The European Journal of Management and Public Policy

VOLUME 3 • No.1 (2004)
ISSN 1726-6475

EUROPEAN CENTER FOR PEACE AND DEVELOPMENT
UNIVERSITY FOR PEACE ESTABLISHED BY THE UNITED NATIONS

The European Journal *of* Management *and* Public Policy

VOLUME 3 • No.1 (2004)
ISSN 1726-6475

Contents

published by:

ECPD

EUROPEAN CENTER FOR PEACE AND DEVELOPMENT
OF THE UNIVERSITY FOR PEACE ESTABLISHED BY THE UNITED NATIONS

European Journal of Management and Public Policy
Academic Journal and Professional Forum on Interface between Business and Society

Published by the European Center for Peace and Development of the University for Peace established by the United Nations

For the Publisher: **Prof. dr Negoslav P. Ostojić**, ECPD Executive Director

ISSN 1726-6475

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MERVYN K LEWIS

Islamic financing: an introduction

Islam bans Muslims from taking or giving interest (the Arabic term for which is *riba*). Technically, *riba* refers to the addition in the amount of the principal of a loan according to the period for which it is loaned and the amount. While earlier there was some debate as to whether *riba* relates to interest or to excessive interest, there now appears to be a consensus of opinion among Islamic scholars that the term extends to all forms of interest. Financial systems based on Islamic tenets are therefore dedicated to the elimination of the payment and receipt of interest in all forms. It is this taboo that makes Islamic banks and other financial institutions different in principle from their Western counterparts.

Instead, the operations of Islamic financial institutions primarily are based on profit-and-loss sharing arrangements. An Islamic bank, for example, does not charge interest but rather participates in the yield resulting from the use of funds. The depositors also share in the profits of the bank according to a predetermined profit-and-loss sharing ratio. There is thus a partnership between the Islamic bank and its depositors, on one side, and between the bank and its investment clients, on the other, as a manager of depositors' resources in productive uses. This is in contrast with a conventional bank which mainly borrows funds with interest on one side of the balance sheet and lends funds with interest on the other.

Islam is not the only (or indeed even the first) religion to ban interest. In Ancient India, laws based on the Veda, the oldest scriptures of Hinduism, condemned usury as a major sin and restricted the operation of interest rates (Gopal, 1935; Rangaswami, 1927). In Judaism, the Torah (the Hebrew name of the Law of Moses or the Pentateuch, the first five books of the Old Testament) prohibited usury amongst the Jews and at least one authority sees in the Talmud (the Oral Law which supplements the Written Scriptures for Orthodox Jews) a consistent bias against 'the appearance of usury or profit' (Neusner, 1990). Under Christianity, prohibitions or severe restrictions upon usury operated for well over 1400 years – longer than Islam has been in operation as a religion. Generally, these controls meant that any taking of interest was forbidden. But gradually only exorbitant interest came to be considered usurious and in this particular form, usury laws of some sort preventing excessive interest, remain in force today in many Western countries (and also in some Muslim countries).

The question of why Christianity relaxed and eventually retreated from the ban on usury, while Islam has not, is an interesting one that does not lend itself to a simple answer, revolving around issues relating to the growth in trade and commerce, the rise of Protestantism and revisionist interpretations of the meaning of interest and usury (Lewis, 1999). What does seem apparent, however, is that in medieval Christianity too much effort was devoted by Christian lenders and borrowers to getting around the prohibition on interest, and by the Church to condemning and rooting out the evaders, than to finding acceptable non-interest alternatives to usury. In Islam, compliance has been left as a matter for the individual (and his Maker), but Islamic intellectuals, jurists and bankers have spent much effort examining the legitimacy of particular transactions and formalising procedures which have enabled everyday banking, finance and commerce to be conducted on an interest-free basis using profit-and-loss sharing techniques.

Although a large number of different contracts feature in Islamic financing, certain types of transaction are central: trustee finance (*mudaraba)*; equity participation (*musharaka)* and 'mark-up' methods. *Mudaraba* is a profit and risk sharing contract where one party entrusts funds to an investor in return for a predetermined share in the profit/loss outcome of the project concerned. This principle lies at the heart of the system of Islamic banking since most funds are provided to an Islamic bank under such arrangements. Under *musharaka,* on the other hand, there is usually more than one single contributor of funds; all of the parties invest in varying proportions and the profits or the losses are shared according to their contributions in the project. The *musharaka* involves a more active partnership between entities who pool their capital and manage and control the enterprise together, with profits and losses divided amongst them according to a prearranged formula. When we add to these two the idea of 'mark-up', for which there are a great number of variants, where assets and other items are acquired for later re-sale or lease with a mark-up on purchase price, we have the main ingredients of the Islamic alternatives to having banks borrow and lend with interest.

Profit-sharing arrangements such as *mudaraba* and *musharaka* almost certainly pre-date the genesis of Islam. Business partnerships based on what was in essence the *mudaraba* concept co-existed in the pre-Islamic Middle East along with interest loans as a means of financing economic activities (Crone, 1987; Kazarian, 1991; Cizaka, 1995). Following the birth of Islam, interest-based financial transactions were forbidden and all finance had to be conducted on a profit-sharing basis. The business partnership technique, utilising the *mudaraba* principle, was employed by the Prophet Muhammad (pbuh) himself, when acting as an agent (*mudarib*) for his wife Khadija, while his second successor Umar ibin al-Khattab invested the money of orphans with merchants engaged in trade between Medina and Iraq. Simple profit-sharing business partnerships of this type continued in virtually unchanged form over the centuries, but they did not develop into vehicles for large-scale investment

involving the collection of large amounts of funds from large numbers of individual savers. This development did not happen until the growth of Islamic financial institutions.

Thirty years ago Islamic banking was virtually unknown. Since the mid-1970s, it has expanded so that at present there are about 70 countries encompassing most of the Muslim world, which have some form of Islamic financial institutions operating. In Pakistan, Iran and Sudan, all banks operate under Islamic financing principles. Elsewhere, in the mixed systems, the Islamic banks are in the minority and operate alongside conventional banks. This includes locations as diverse as Australia, the Bahamas, Canada, Cayman Islands, Denmark, Guernsey, Jersey, Ireland, Luxembourg, Switzerland, the United Kingdom, the United States and the Virgin Islands. In all, there are over 180 dedicated Islamic banks and financial institutions in operation. Their number is increasingly swelled by conventional international banks offering specialised Islamic 'windows' for Muslim customers who want their business with the banks conducted in an Islamic-acceptable way. Whilst hard figures are difficult to ascertain, the Islamic finance industry is said to have $200 billion to $250 billion in assets under management, expanding at a growth rate of 10-15 per cent per annum (Finance and Investment, 2004).

Development of the Islamic finance industry is usually dated from the creation of the Islamic Development Bank, although there were a number of experiments with Islamic banking prior to then in India, Pakistan and Egypt (Lewis and Algaoud, 2001). The Islamic Development Bank, based in Jeddah, was the first Islamic financial institution to benefit from the inflow of oil-related wealth. Established in 1974 with the support of the Saudi Arabian government and the Organization of Islamic Countries (OIC) it is primarily an intergovernmental bank aimed at providing funds for development projects in member countries, and provides fee-based financial services and profit-sharing financial assistance to member countries. Operations are free of interest and are explicitly based on Islamic principles. Its present membership comprises 55 countries, but the majority share ownership is held by Saudi Arabia, Kuwait, UAE and Libya. Despite the IDB's multilateral origins, it gave momentum to the Islamic banking movement generally, being followed soon afterwards by both private and government institutions.

It is thus highly appropriate that the first article in this collection is contributed by *Munawar Iqbal*, Chief of Research, Islamic Banking and Finance Division of the Islamic Development Bank. From this perspective, Dr Iqbal provides a valuable overview of the current position of Islamic financing at a global level, covering developments in banking, investment funds, and the Islamic international financial institutions. He argues that the distinctive feature of Islamic banks comes from the risk-sharing arrangements, contracting methods, and the 'ethical investment' rules applied to financing activities. But there are also important differences in performance. Case studies are provided of banks in a number of regions and a comparison is made of the

growth performance of selected groupings of Islamic and conventional banks. It is found that Islamic banks both maintained a higher capital to assets ratio than conventional banks over the period studied (1990-1997) and used their resources more efficiently as indicated by the deployment of funds and the return on equity. These results have found confirmation in a similar study with more recent data examining the performances of 43 Islamic banks worldwide over the 1994-2001 period (Hassan and Bashir, 2004). While Islamic bank profitability depends on a host of internal bank specific and external macroeconomic characteristics, those Islamic banks with high capital and loan-to-asset ratios are shown to exhibit higher profitability.

What Iqbal calls the 'moral dimension' (or ethical investment aspect) of Islamic financing is of special significance in the case of Islamic investment funds. The main question from the Islamic point of view is whether investments in international equity markets are acceptable under *shari'a* (Hassan, 2001). There is no doubt that enterprises dealing in the supply, manufacture or service of products prohibited by Islam (*haram*), such as *riba*, pork, alcohol, gambling, etc. cannot be acceptable. But companies which are not involved in the above *haram* activities can be considered acceptable. The main objection against them is that in their own internal accounting and financial dealings they lend and borrow from *riba* banks and other institutions, even though the fact remains that their main business operations do not involve prohibited activities. Essentially, non-Muslim entities cannot be expected to work under the Islamic code of conduct, and in any case only a negligible amount of interest may be involved. In this case, if some income from interest-bearing accounts is incorporated, the proportion of such income in the dividends paid to the Islamic shareholders must be given by them to charity. For example, if 5 per cent of the whole income of a company has come from interest-bearing returns, 5 per cent of the dividend must be given to charity. This process is known as 'purification'.

However, there still remains the process of 'screening' to identify those companies the activities of which might be considered unacceptable from an Islamic point of view. Obtaining such information could be costly for an individual fund, but has been made less so by the creation in February 1999 of the Dow Jones Islamic Market Index (DJIM), launched in Bahrain, and in November, 1999 of the Financial Times Islamic Index Series, of which there are now five FTSE Islamic indices (Global, Americas, Europe, Pacific Basin and South Africa). These indices were followed by the Malaysian Kuala Lumpur Syariah Index aimed at investors who follow Islamic investment guidelines, and they classify quoted companies according to a number of screens. After removing companies with unacceptable core business activities, the remaining list is tested by a financial-ratio 'filter', the purpose of which is to remove companies with an unacceptable debt ratio. Both indices use a debt/asset ratio of less than one-third, while the DJIM uses two additional filters: accounts receivable/total assets must be less than 49 per cent and interest income/operating

income must be less than 10 per cent. Both series report a dividend cleansing/impure income figure. Here 'tainted dividend' receipts relate to the portion, if any, of a dividend paid by a constituent company that has been determined to be attributable to activities that are not in accordance with *shari'a* principles and therefore should be donated to a proper charity or charities. However, such cleansing cannot be counted as part of *zakat* obligations. In this, and other matters, compilers of the indices are advised by *shari'a* scholars.

There are obvious parallels in this selection process with the ethical investment movement that operates in the West. A number of investment advisers in Western countries have been providing investment advice for over three decades to clients who wish to invest in ethical unit trusts (mutual funds), that is, those investment funds which do not invest in the shares of companies trading in tobacco, alcohol, gambling, or arms. The main difference is that the determination of whether an investment is ethical or unethical is made by the fund managers, based on information received from various professional bodies. In the case of Islamic investment funds, the investment firms must use a *shari'a* management process, overseen by a *shari'a* advisory board for each fund, comprising scholars, jurists and professionals who ensure that funds are being invested Islamically. This board is responsible for portfolio purification, screening and monitoring stocks, overseeing management fees, fund documentation and the collection and distribution of *zakat* (almsgiving).

Until now, there has been no systematic examination of the performance of the Islamic funds. *Said Elfakhani, Yusuf Sidani and Omar Fahel* in the second article in this collection provide such an examination comparing a sample of 46 Islamic mutual funds, classified into eight sector-based categories, against an overall Islamic index and a conventional one. Over the whole period studied, from 1997 to 2002, it was found that the behaviour of Islamic mutual funds does not differ markedly from that of conventional funds, with some Islamic funds over-performing their benchmarks and others under-performing, as would be expected for a portfolio of different fund types. One interesting discovery is the strong performance of the Islamic funds over the recession period, leading the authors to suggest that conventional investors might want, on these grounds alone, to consider the Islamic funds in their portfolio collection.

The other three papers in this special issue also deal with different aspects of the ethical or moral dimension of Islamic financing. A prohibition on games of chance is explicit in the Holy Qur'an which uses the word *maysir* for games of hazard, implying that the gambler strives to amass wealth without effort, and the term is now applied generally to all gambling activities. Gambling in all its forms is forbidden in Islamic jurisprudence. Along with explicit forms of gambling, Islamic law also forbids any business activities which contain any element of gambling (Siddiqi, 1985). The *shari'a* determined that in the

interests of fair, ethical dealing in commutative contracts, unjustified enrichment through games of pure chance should be prohibited.

Economic transactions involving elements of speculation, *gharar* (literally 'hazard') are also condemned by Islam. In business terms, *gharar* means to undertake a venture blindly without sufficient knowledge or to undertake an excessively risky transaction, although minor uncertainties can be permitted when there is some necessity. In a general context, the unanimous view of the jurists holds that in any transaction, by failing or neglecting to define any of the essential pillars of contract relating to the consideration or measure of the object, the parties undertake a risk which is not indispensable for them. Such risk is deemed unacceptable and tantamount to speculation due to its inherent uncertainty.

Speculative transactions with these characteristics are therefore prohibited. This prohibition applies in a number of circumstances such as when the seller is not in a position to hand over the goods to the buyer or when the subject matter of the sale is incapable of acquisition, that is, short-selling. Speculative business such as buying goods or shares at low prices and selling them for higher prices in the future is considered to be illicit. *Gharar* applies also for investments such as trading in futures on the stock market; indeed, *gharar* is present in all future sales in the eyes of many Islamic jurists.

In the third paper in this collection, *Obiyathulla Bacha* summarises the main rulings by jurists of Islamic law on the question of futures and option contracts. Sunni legal doctrine has four main schools, each with its own system of theory and applications of law, although each recognises the legitimacy of the others. The four orthodox schools are the Hanafi (rationalist), the Maliki (traditionalist), the Hanbali (fundamentalist) and the Shafii (moderate). The Hanafi school is followed by the majority of sunni Muslims in Lebanon, Iraq, Syria, Turkey, Afghanistan, Pakistan, Bangladesh and in various places in India. The Moors who ruled Spain were followers of the Maliki school which, nowadays, is found mostly in Africa. The Hanbali school is predominant in Saudi Arabia. Followers of the Shafii school today are found extensively in South East Asia. It would seem that the rulings of scholars based in Malaysia are more permitting of futures and options than those emanating from Jeddah. The overriding concern of those who do not consider them permissible would appear to be that their use encourages speculative behaviour.

This absence of a consensus amongst jurists on the permissibility of derivatives creates a problem for Islamic fund managers and those enterprises with risks from equities and currency positions. It is against this background that Bacha proposes the establishment of an Islamic Equity Guarantee Corporation, dedicated to selling partial equity portfolio insurance to Islamic mutual funds in an Islamic-acceptable way. As well as restricting the portfolio insurance hedge to be a partial rather than a total hedge, the viability of the pro-

posal depends on the ability to spread portfolio risks across a range of Islamic assets and a variety of Muslim countries.

The need for insurance services to be Islamic-acceptable is not confined to portfolio insurance and hedging. It also applies to all forms of insurance, since the rejection of *gharar* has led to the condemnation of some or all types of insurance by Muslim scholars, on the grounds that insurance involves an unknown risk. Further, an element of *maysir* arises as a consequence of the presence of *gharar.* From the viewpoint of Islamic law, there are three main problems with conventional, especially life insurance (Lewis, 2003). First, it violates the prohibition of *gharar* (uncertainty) since the benefits to be paid depend on the outcome of future events that are not known at the time of signing the contract. This prohibition in particular nullifies a conventional whole-of-life policy contract because this type of policy is based on a time frame, the lifetime of the insured, which is not known and cannot be known until the event (death) itself occurs. Second, insurance is regarded as *maysir* (gambling) because policyholders are held to be betting premiums on the condition that the insurer will make payment (indemnity) consequent upon the circumstances of a specified event. For example, when policyholders take out a pure endowment policy they are taking a gamble that they will still be alive by the end of the term of the policy to receive the benefits stated in the contract. Third, in addition, many forms of life insurance are merely thinly disguised investment methods and the majority of insurance companies conduct their business by investing collected premiums and reinsuring with other insurers, thereby contravening the Islamic laws regarding *riba* along with *gharar* and *maysir*.

These concerns have led to the development of *takaful* (cooperative) insurance, based on Islamic principles. There are now over 50 companies operating in 22 countries providing *takaful* services (Lewis, 2004). These companies can be seen as constituting the third main plank of the Islamic finance industry, alongside Islamic banks and Islamic investment funds. By far the country in which Islamic insurance is growing most rapidly is Malaysia. The performance of the *takaful* companies in Malaysia is the subject of the fourth article in this issue.

Hairul Annuar, Saifal Rosly and Hafiz Rashid in their article examine the different types of *takaful* contracts on offer, a distinctive feature of Malaysia being the significance of family *takaful* (the Islamic equivalent of life insurance) in the expansion of *takaful* in the Malaysian insurance market. The authors study the performance of the Malaysian Islamic insurance companies in terms of income, expenditure, profit, return on equity, *zakat* contributions, and the composition of the balance sheet. Their comparison also reveals that *sharia* board rulings have influenced how certain management expenses are treated in the accounts, and the two *takaful* companies have adopted different conventions with respect to agency costs. This is because Muslim jurists are divided over the issue of how to treat *al-wakalah* (agency) arrangements

in *takaful.* In Malaysia, a majority of Muslims usually conform to the *Shafii's* view on devotional matters. However, on matters that concern business transactions (*muamalat*), Muslims tend to take various views including from the other schools and this diversity has found reflection in the accounting policies of the insurance companies. Nevertheless, despite these different interpretations, the *shar'ia* supervisory boards play a key role in ensuring that the operations of Islamic financial institutions remain within the overall guidelines provided by the Holy law of Islam.

In the final article in this special issue, *Habib Ahmed*, of the Islamic Development Bank, considers the role of Islamic banking in economic development. Whilst Islamic banking derives its specific *raison d'etre* from the elimination of interest in banking operations, there has always been the belief that there is more to Islamic banking, such as its contribution to economic development; to a more equitable distribution of income and wealth, and increased equity participation in the economy (Chapra, 1982). One of the most noteworthy developments in policies towards poverty alleviation that has taken place in recent decades is the growth in institutions providing 'microfinance'. The Grameen Bank in Bangladesh is undoubtedly the most well-known of these. Some Islamic institutions have also been established for the same purposes. The author argues that Islamic banks have a special role to play in complementing and expanding this agenda and he draws on the experience of the Islamic Bank Bangladesh to illustrate this potential.

Overall, the five articles demonstrate that Islamic financing is an evolving area, and that product innovation within *shari'a* guidelines is the key element governing the future of Islamic financing. The formation of the system of Islamic banking thirty years ago was a path-breaking innovation that showed Muslims how they could undertake banking and finance, whilst maintaining faith with their religious convictions. In effect, Islam developed instruments and systems that have allowed those wishing to avoid *riba* and engage in banking to do so in ways consistent with *shari'a.* Islamic investment trusts, *takaful* insurance, Islamic microfinancing and the search for new ways of managing risks – all of which have been examined here – illustrate that this process of innovation in Islamic financing is continuing.

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MUNAWAR IQBAL

Islamic Banking in Practice*

Abstract

Theoretical arguments and models developed by Islamic economists and the successful practice of hundreds of institutions in heterogeneous conditions testify to the viability of Islamic banking. This paper explains how Islamic banking works and what it offers as an alternative model of financial intermediation. The paper examines its distinguishing features, its strengths and its weaknesses. It also evaluates the performance of Islamic banks and compares it with conventional banks. It is found that based on objective criteria, Islamic banking out-performs conventional banking in most areas.

1. Introduction

1.1 Why is Islamic Banking needed?

In any economy, there is a need to transfer funds from savers to investors because people who save are frequently not the same people who have the ability to exploit the profitable investment opportunities, i.e., they are not entrepreneurs. This function is performed through the process of financial intermediation in the financial markets. Financial intermediation enhances the efficiency of the saving/investment process by eliminating the mismatches inherent in the needs of surplus and deficit units of an economy. The surplus units are often small households, which save relatively small amounts and the deficit units are the firms who often need relatively large amounts of cash. Financial intermediaries remove this size mismatch by collecting the small savings and packaging them to make them suitable to the needs of the users. In addition, users of funds in general need funds for relatively long-term deployment, which cannot be met by individual suppliers of funds. This creates the mismatch in the maturity and liquidity preferences of individual savers and users of funds. The intermediaries resolve the conflict, again by pooling the small funds. Moreover, the risk preferences of small suppliers and large users of funds are also different. It is often considered that small savers are risk averse and prefer safer placements whereas the fund users deploy the funds in risky projects. Therefore, the funds cannot be directly supplied. The

* The views expressed in this paper are personal views of the author and do not in any way represent those of the institution that he is affiliated with.

role of the intermediary again becomes crucial. They can substantially reduce this risk through portfolio diversification. Furthermore, small savers cannot efficiently gather information about investment opportunities. Financial intermediaries are in a much better position to collect such information, which is crucial for making the investment successful.

The role and functions of banks outlined above are indeed highly useful and socially desirable, but unfortunately, interest plays a central role in each of these functions. Islamic financial intermediation endeavours to replace interest by partnership between owners of capital and human resources (entrepreneurs) on the basis of profit sharing as a basic form of co-operation between capital and entrepreneur. The functions that the banks perform are important whether the economy concerned is secular or Islamic. People need banking services. However, conventional banks perform their borrowing and lending activities and most other functions on the basis of fixed interest. In an Islamic economy, both giving and taking of interest is prohibited. Now, since the banking services are needed but interest is prohibited, Islamic economies have to find alternative ways of performing various banking functions. This requirement provides the rationale of Islamic banking.

Islam fully recognises the useful role that financial intermediation can play. However, in Islam the concept of financial intermediation is interwoven with the production and exchange of real goods and services. Historically, the role of a financial intermediary in the Islamic economy is found in the principle of *al mudarib udarib*; a practice which has existed in Islamic history since early centuries. It can be expressed as, *"the one who mobilises funds, on a profit-sharing basis and extends these funds to the users on the same basis"*. In the early Islamic period, most caravan trades were financed by *mudarabah* (trust financing) and money transfer (*suftaja*) was quite common amongst businessmen. Islamic scholars consider the earning of profits from an intermediary role as a genuine occupation.

1.2 How Islamic Banking Works

An Islamic bank is a deposit-taking banking institution whose scope of activities includes all currently known banking activities, excluding borrowing and lending on the basis of interest. On the liabilities side, it mobilises funds on the basis of a *mudarābah* or *wakālah* (agent) contract. It can also accept demand deposits which are treated as interest-free loans from the clients to the bank and which are guaranteed. On the assets side, it advances funds on a profit-and–loss sharing or a debt-creating basis, in accordance with the principles of the *Shari'ah*. It plays the role of an investment manager for the owners of time deposits, usually called investment deposits. In addition, equity holding as well as commodity and asset trading constitute an integral part of Islamic banking operations. An Islamic bank shares its net earnings with its depositors in a way that depends on the size and date-to-maturity of

each deposit. Depositors must be informed beforehand of the formula used for sharing the net earnings with the bank.

An Islamic bank, like other banks, is a company whose main business is to mobilise funds from savers and supply these funds to businessmen/entrepreneurs. It is organised as a joint stock company with the shareholders supplying the initial capital. The functions of Islamic banks and other financial intermediaries are similar to their conventional counter-parts. Muslim economists have shown that there are alternative Islamic modes through which these functions can be performed. In fact, they have shown that Islamic models can perform these functions better.

Several theoretical studies of Islamic banking and finance introduced a pure profit-sharing model and compared it with a pure interest-based model. While Islamic banks are expected to mix profit-sharing with debt-creating modes, the pure profit-sharing model is useful as a comparative approach. Several scholars have argued that a system, which is based on profit sharing, is not only viable, but also carries with it many advantages which make it superior to an interest-based one. (For more detailed discussions of various points see Chapra, 1985 and Mirakhor, 1997).

i) The allocation of financial resources on the basis of profit-and-loss sharing gives maximum weight to the profitability of the investment, whereas an interest-based allocation gives it to credit worthiness. We can expect the allocation made on the basis of profitability to be more efficient than that made on the basis of interest.

ii) A system based on profit sharing would be more stable compared to one based on a fixed interest rate on capital. In the first, the bank is obliged to pay a fixed return on its obligations regardless of their fate, should the economic conditions deteriorate. In the latter, the return paid on the bank's obligations depends directly on the returns of its portfolio of assets. Consequently, the cost of capital would adjust itself automatically to suit changes in production and in other business conditions. Furthermore, any shock, which might befall the obligations' side of the balance sheet, would be automatically absorbed. This flexibility not only prevents the failure of the enterprises seeking funds, but also ensures the existence of a necessary harmony between the firm's cash flow and its repayment obligations, that element which enables the financial system to work smoothly.

iii) Since bank assets are created in response to investment opportunities in the real sector of the economy, the real factors related to the production of goods and services (in contrast with the financial factors) become the prime movers of the rates of return to the financial sector.

iv) The transformation of an interest-based system into one based on profit-sharing helps achieve economic growth as this results in increasing the supply of venture or risk capital and, consequently, encourages new project

owners to enter the realm of production as a result of more participation in the risk-taking.

In addition to these theoretical arguments, empirical evidence also confirms the superiority of Islamic over conventional banking. Some of this evidence is reviewed later in the paper.

While a conventional bank uses the rate of interest for both obtaining funds from savers and supplying these funds to businessmen, an Islamic bank performs these functions using various financial products compatible with the Islamic law. A large number of such products are now available. Some of these have been briefly described below.

Liabilities side

On the resource mobilisation side, an Islamic bank uses either the contract of *mudarabah* or *wakalah* with the fund owners. Under the first contract, the net income of the bank is shared between shareholders and the investment deposit holders according to a predetermined profit sharing formula. In the case of loss, the same is shared in proportion to the capital contributions. As far as the nature of investment deposits are concerned, these could be either general investment deposits that enter into a pool of investment funds or specific investment accounts in which deposits are made for investment in particular projects. In addition, there are current accounts that are in the nature of an interest-free loan to the bank. The bank guarantees the principle but pays no profit on these accounts. The bank is allowed to use these deposits at its own risk.

In the case of a *wakalah* contract, clients give funds to the bank that serves as their investment manager. The bank charges a predetermined fee for its managerial services. The profit or loss is passed on to the fund providers after deducting such a fee. This is the case of Fund Management, an activity that Islamic financial institutions are increasingly getting into.

Assets side

On the assets side, the bank uses a number of financial products for providing finance to businesses, none of which involves interest. Some of these are described below:

I. *Mudarabah (Passive Partnership)*

This is a contract between two parties: a capital owner (*rabb al-mal*) and an investment manager (*mudarib*). Profit is distributed between the two parties in accordance with the ratio that they agree upon at the time of the contract. Financial loss is borne by the capital owner; the loss to the manager being the

opportunity cost of his own labour, which failed to generate any income for him. Except in the case of a violation of the agreement or default, the investment manager does not guarantee either the capital extended to him or any profit generation. Some other important features of the *mudarabah* contract include:

- While the provider of capital can impose certain mutually agreed conditions on the manager he has no right to interfere in the day-to-day work of the manager.
- *Mudarabah* is one of the fiduciary contracts (*uqud al-amanah*). *Mudarib* is expected to act with utmost honesty, otherwise he is considered to have committed a grave sin (in addition to worldly penalties). This has important implications for the moral hazard problem.
- The liability of the *rabb al-mal* is limited to the extent of his contribution to the capital and no more.
- The *mudarib* is not allowed to commit the *mudarabah* business for any sum greater than the capital contributed by the *rabb al-mal*.
- All normal expenses related to *mudarabah* business, but not the personal expenses of the *mudarib,* can be charged to the *mudarabah* account.
- No profit distribution can take place (except as an ad hoc arrangement, and subject to final settlement), unless all liabilities have been settled and the equity of the *rabb al-mal* restored.

As a mode of finance applied by Islamic banks, on the liabilities side, the depositors serve as *rabb-al-mal* and the bank as the *mudarib*. *Mudarabah* deposits can be either general, which enter into a common pool, or restricted to a certain project or line of business. On the assets side, the bank serves as the *rabb-al-mal* and the businessman as the *mudarib* (manager). However the manager is often allowed to mix the *mudarabah* capital with his own funds. In this case profit may be distributed in accordance with any ratio agreed upon between the two parties, but the loss must be borne in proportion to the capital provided by each of them.

II. *Musharakah (Active Partnership)*

A *musharakah* contract is similar to *mudarabah,* with the difference that in the case of *musharakah* both partners participate in the management and provision of capital and also share in the profit and loss. Profits are distributed between partners in accordance with agreed ratios, but the loss must be distributed in proportion to the share of each in the total capital.

III. *Diminishing Partnership*

This is a contract between a financier (the bank) and a beneficiary in which the two agree to enter into a partnership to own an asset, but on the condi-

tion that the financier will gradually sell his share to the beneficiary at an agreed price and in accordance with an agreed schedule.

IV. *Bay' Murabahah (Sales Contract at a Profit Mark-up)*

In the classical *fiqh* literature, there is a sales contract called *bay' mu'ajjal* which refers to sale of goods or property against deferred payment (either in lump sum or instalments). *Bay' mu'ajjal* need not have any reference to the profit margin that the supplier may earn. Its essential element that distinguishes it from cash sale is that the payment is deferred. Strictly speaking, the deferred payment can be higher than, equal to or lower than the cash price. In practice, however, this sale takes the form of *bay' al-murabahah*, which stands for the supply of goods or property by the seller to the buyer at cost plus a specified profit margin mutually agreed between them.

Islamic banks now use this contract as a mode of finance in the following manner. The client orders an Islamic bank to purchase for him a certain commodity at a specific cash price, promising to purchase such commodity from the bank once it has been bought, but at a deferred price, which includes an agreed upon profit margin called mark-up in favour of the bank.

Thus, the transaction involves an order accompanied by a promise to purchase and two sales contracts. The first contract is concluded between the Islamic bank and the supplier of the commodity. The second is concluded between the bank and the client who placed the order, after the bank has possessed the commodity, but at a deferred price, that includes a mark-up. The deferred price may be paid as a lump sum or in instalments. In the contract between the Islamic bank and the supplier, the bank often appoints the person placing the order (the ultimate purchaser) as its agent to receive the goods purchased by the bank.

V. *Ijarah (Leasing)*

In the simple lease contract the usufruct generated over time by an asset, such as machinery, airplanes, ships or trains is sold to the lessee at a predetermined price. This is called an operating lease, as against a finance lease. The operating lease has a number of features that distinguish it from other forms of leasing. Firstly, the lessor is himself the real owner of the leased asset and, therefore, bears all the risks and responsibilities of ownership. All defects, which prevent the use of the equipment by the lessee, are his responsibility, even though it is possible to make the lessee responsible for the day-to-day maintenance and normal repairs of the leased asset. Secondly, the lease is not for the entire useful life of the leased asset but rather for a specified short-term period (for a month, a quarter, or a year) unless renewed by mutual consent of both the parties.

VI. *A Lease Ending in the Purchase of the Leased Asset*

Since the entire risk is borne by the lessor in the operating lease, there is a danger of misuse of the leased asset by the lessee. The financial lease helps take care of this problem by making the lease period long enough (usually the entire useful life of the leased asset), to enable the lessor to amortize the cost of the asset with profit. At the end of the lease period the lessee has the option to purchase the asset from the lessor at its market value at that time. The lease is not cancellable before the expiry of the lease period without the consent of both the parties. There is, therefore, little danger of misuse of the asset.

A financial lease has other advantages too. The leased asset serves as security and, in case of default on the part of the lessee, the lessor can take possession of the equipment without a court order. It also helps reduce the lessor's tax liability due to the high depreciation allowances generally allowed by tax laws in many countries. The lessor can also sell the equipment during the lease period such that the lease payments accrue to the new buyer. (The new buyer has to agree to continue the lease on the conditions previously agreed unless the lessee willingly agrees to any new conditions). This enables the lessor to get cash when he needs liquidity. This is not possible in the case of a debt because, while the *shari'ah* allows the sale of physical assets, it does not allow the sale of monetary debts except at their nominal value.

Some of the *fuqaha*' have expressed doubts about the permissibility of financial lease. The rationale they give is that the long-term and non-cancellable nature of the lease contract shifts the entire risk to the lessee, particularly if the 'residual' value of the asset is also fixed in advance. The end result for the lessee may turn out to be worse than the outright purchase of the asset through an interest-bearing loan. A financial lease has thus the potential of becoming more exploitative than outright purchase. Suppose the lease contract is for five years. The lessee would have to continue making lease payments even if he no longer needs the asset, say, after two years. In the case of a purchase through an interest-bearing loan, the purchaser can sell the asset in the market and repay the loan, thus reducing his loss. This he cannot do in a financial lease. If he is unable to make the lease payments, he may lose his stake in the asset even though he has paid a part of the asset price beyond the rental charge he would normally pay in an operating lease.

However, there are *fuqaha*' who consider financial lease to be permissible if certain conditions are satisfied. Firstly, the lessor must bear the risks of leasing by being the real owner of the leased asset. He cannot lease what he does not own and possess, and should be responsible for all the risks and responsibilities related to ownership. Therefore, a leasing contract where the lessor acts only as an intermediary between the supplier and the lessee and plays the role of only a financier, with ownership of the asset being nothing more than a legal device to provide security for repayment of the loan and legal protection in case of default, is not allowed. In this case the lessor leases

an asset before buying it and taking possession of it, and receives a reward without taking any risk. Secondly, lease payments cannot start until the lessee has actually received possession of the leased asset and can continue only as long as it remains usable by him. Thirdly, all manufacturing defects and later damages which are beyond the control of the lessee, should be the lessor's responsibility. Some of these can be insured against, but this has to be done by the lessor at his own cost. The lessee can, however, be made responsible for the proper upkeep and maintenance of the leased asset.

As a form of financing used by Islamic banks in practice, the contract takes the form of an order by a client to the bank, requesting the bank to purchase a piece of equipment, promising, at the same time, to lease it from the bank after it has been purchased. Rent instalments are calculated in such a manner as to include, in reality, recovery of the cost of the asset plus the desired profit margin. Thus, this mode of financing includes a purchase order, a promise to lease, and a leasing contract with a provision to transfer ownership of the leased asset to the lessee at the end of the lease agreement. This transfer of ownership is made through a new contract, in which the leased asset is either given to the lessee as a gift or is sold to him at a nominal price at the end of the lease agreement. According to a decision of the OIC Fiqh Academy, this second transfer-of-ownership contract should be signed only after termination of the lease term, on the basis of an advance promise to affect such a transfer of ownership to the lessee.

VII. *Al-Istisna'(Contract of Manufacture) and Al- Istisna' Al-Tamwili (Financing by Way of Istisna')*

Al-Istisna' is a contract in which a party orders another to manufacture and provide a commodity, the description of which, delivery date, price and payment date are all set out in the contract. According to a decision of the OIC Fiqh Academy, this type of contract is of a binding nature and the payment of the price could be deferred.

Al-Istisna' Al-Tamwili, which is used by Islamic banks, consists of two separate *istisna'* contracts. The first is concluded between the beneficiary and the bank, in which the price is payable by the purchaser in future, in agreed instalments and the bank undertakes to deliver the requested manufactured commodity at an agreed time. The second *istisna'* contract is a subcontract concluded between the bank and a contractor to manufacture the product according to prescribed specifications. The bank would normally pay the price in advance or during the manufacturing process in instalments. The latter undertakes to deliver the product to the bank on the date prescribed in the contract, which is the same date as that stated in the first *istisna'* contract. The original purchaser (i.e., the bank's client) may be authorised to receive the manufactured commodity directly from the manufacturer.

VIII. *Salam*

Salam is a sales contract in which the price is paid in advance at the time of contracting, against delivery of the purchased goods/services at a specified future date. Not every commodity is suitable for a *salam* contract. It is usually applied only to fungible commodities.

Islamic banks can provide financing by way of a *salam* contract by entering into two separate *salam* contracts, or one *salam* contract and an instalments sale contract. For example, the bank could buy a commodity by making an advance payment to the supplier and fixing the date of delivery as the date desired by its client. It can then sell the commodity to a third party either on a *salam* or instalments sale basis. If the two were *salam* contracts, the second contract would be for delivery of the same quantity, description, etc., as that constituting the subject-matter of the first *salam* contract. This second contract is often concluded after the first contract, as its price has to be paid immediately upon conclusion of the contract. To be valid from the *shari'ah* point of view, the second contract must be independent, i.e., not linked to the delivery in the first contract. Should the second contract consist of an instalments sale, its date should be subsequent to the date on which the bank would receive the commodity.

1.3. Distinguishing Features of Islamic Banking

While Islamic banks perform mostly the same functions as the conventional banks, they do it in distinctly different manners. Some of the distinguishing features of Islamic banking are given below:

1.3.1. Risk Sharing

The most important feature of Islamic banking is that it promotes risk sharing between the provider of funds (investor) and the user of funds (entrepreneur). By contrast, under conventional banking, the investor is assured of a predetermined rate of interest. Since the nature of this world is uncertain, the results of any project are not known with certainty ex-ante. Therefore, there is always some risk involved. In conventional banking, all this risk is borne by the entrepreneur. Whether the project succeeds and produces a profit or fails and produces a loss, the owner of capital gets away with a predetermined return. In Islam, this kind of unjust distribution is not allowed and hence in Islamic banking both the investor and the entrepreneur share the results of the project in an equitable way. In case of profit, both share it in a pre-agreed proportion. In case of loss, all financial loss is borne by the capitalist and the entrepreneur loses his labour.

1.3.2. Emphasis on Productivity as Compared to Credit Worthiness

Under conventional banking, all that matters to a bank is that its loan and the interest thereupon are paid on time. Therefore, in granting loans, the dominant consideration is the credit-worthiness of the borrower. Under Profit Loss Sharing (PLS) banking, the bank will receive a return only if the project succeeds and produces a profit. Therefore, an Islamic bank will be more concerned with the soundness of the project and the business acumen and managerial competence of the entrepreneur. This feature has important implications for the distribution of credit as well as the stability of the system. Some of these implications will be mentioned later in this paper.

1.3.3. Moral Dimension

Conventional banking is secular in its orientation. As against this, in the Islamic system all economic agents have to work within the moral value system of Islam. Islamic banks are no exception. As such, they cannot finance any project which conflicts with the moral value system of Islam. For example, they will not finance a wine factory, a casino, a night club or any other activity which is prohibited by Islam or is **known** to be harmful to society.

1.4. Islamic Banking in Practice

Islamic banking and financial institutions now spread in several Muslim countries. Some non-Muslim countries and/or institutions are also keen to experiment with Islamic financial techniques. Various components of the Islamic financial system are now available in different parts of the world to a varying degree and quality. A detailed and integrated system of Islamic banking and finance is gradually evolving.

Islamic banking began on a modest scale in the early sixties. The earliest attempts in Islamic banking took place in most cases on individual initiative with governments playing no, or at best a passive role. The later growth of the Islamic banking movement has been significantly helped by the encouragement provided by the governments of some Muslim countries. Islamic banks began on private initiative. Islamic banking windows are being encouraged in the conventional banks in addition to pure Islamic financial institutions. The governments of these countries have not committed themselves to the abolition of interest from the economy altogether. Islamic banks exist side by side with interest based banks. The monetary authorities recognise and regulate both conventional and Islamic banking; in some countries aimed at economy wide elimination of interest. These include Pakistan, Iran and Sudan. The establishment of Islamic banks in a number of countries has been effected by special enactments and changes in banking legislation. It should be mentioned that those changes were not intended to confer any undue ad-

vantages on those banks vis-à-vis conventional banks. They were in fact designed to remove some of the obstacles that hindered the establishment of Islamic financial institutions. As a matter of fact, Islamic banks still operate under considerable disadvantages.

In brief, the practice of Islamic banking as it developed during our times has four manifestations:

1. Banks and financial institutions in those countries where promotion of Islamic financial system is receiving active government support.
2. Islamic banks and financial institutions in the private corporate sector working in a mixed environment.
3. Islamic banking practices by some conventional commercial banks and non bank financial institutions.
4. International Financial Institution working on *sharia'h* principles.

In the following sections, a brief account of each category is given.

2. Country-wide Experiences

2.1. Pakistan

The process of economy wide Islamization of the banking system in Pakistan was initiated soon after a declaration by the then President of Pakistan in February 1979 that Government planned to remove interest from the economy within a period of three years and that a decision had been taken to make a beginning in this direction with the elimination of interest from the operations of the House Building Finance Corporation, National Investment Trust and mutual funds of the Investment Corporation of Pakistan. Within a few months of this announcement, these specialised financial institutions took the necessary steps to reorient their activities on a non-interest basis.

The conversion of the operations of commercial banks to a non-interest basis was a much more complex task and took longer than envisaged. To begin with, steps were taken in January 1981 to set up separate counters for accepting deposits on a profit/loss-sharing basis in all the domestic branches of the five nationalised commercial banks. The parallel system, in which savers had the option to keep their money with the banks either in interest bearing deposits or PLS deposits, continued to operate till the end of June 1985. As from 1st July 1985, no banking company was allowed to accept any interest bearing deposits except foreign currency deposits, which continued to earn interest. As from that date, all deposits accepted by a banking company shared in the profit and loss of the banking company, except deposits in current accounts on which no interest or profit was given and whose capital sum was guaranteed.

The central bank of the country issued instructions specifying twelve modes of financing in which funds mobilised by the banks can be employed. These were broadly classified into three groups: (a) loan financing, (b) trade related modes of financing and (c) investment modes of financing. Loan financing took the form either of *qard al-hasanah* loans given on compassionate grounds free of any interest or service charge (repayable if and when the borrower is able to repay) or of loans with a service charge not exceeding the proportionate cost of the operation. Trade related modes of financing included the following: (i) purchase of goods by banks and their sale to clients at appropriate mark up in price on deferred payment basis, (ii) purchase of trade bills, (iii) purchase of moveable or immovable property by the banks from their clients with buy-back agreement or otherwise, (iv) leasing, (v) hire-purchase, and (vi) financing for development of property on the basis of a development charge. Investment modes of financing included the following: (i) *musharakah,* (ii) equity participation and purchase of shares, (iii) purchase of Participation Term Certificates,[1] and *mudarabah* certificates, and (iv) rent sharing.

The central bank of the country was authorised to fix the minimum annual rate of profit which banks should keep in view, while considering proposals for provision of finance, and the maximum rate of profit they may earn. These rates were changed from time to time. It was also laid down that should losses occur, these must be shared by all the financiers in proportion to the respective finances provided by them.

A beginning in the direction of introducing the *mudarabah* technique of financing was made in June, 1980 when a law was promulgated under which companies, banks and other financial institutions could register themselves as *mudarabah* companies and mobilise funds through the issuance of *mudarabah* certificates. Funds obtained through a *mudarabah* could only be used in such businesses which were permitted under the *shari'ah*, and needed prior clearance from a Religious Board established by the government, specifically for the purpose.

Though a number of steps were taken for the elimination of interest from the financial sector in Pakistan, the process of Islamization was slow and selective. Nothing was done to eliminate interest from government transactions. To begin with, commercial banks were precluded from investing PLS deposits in interest bearing government securities. With the withdrawal of this restriction in August 1985, the movement towards an interest free company suffered a serious slowdown. Another disappointing feature of the situation was the lack of any notable progress in the transition to profit/loss sharing on the assets side of the banking system. The Islamization process was marked by another serious deficiency. No institutional mechanism was created for a continuous scrutiny of the

[1] Participation Term Certificates were negotiable instruments designed to replace debentures for meeting medium and long term financing requirements of business concerns. Instead of receiving interest, as in the case of debentures, the holders of these certificates shared in the profit or loss of concerns raising finance through this device.

operating procedures of banks and other financial institutions from the *shari'ah* point of view. Individual scholars who examined these operating procedures pointed out several areas where the actual banking practices showed deviation from *shari'ah*. In December 1991, the Federal *Shari'ah* Court, in one of its judgments, held that the system of mark-up financing as being practiced by banks was not in conformity with the injunctions of Islam. It also took exception to a number of other practices prevailing in the banking sector. The court instructed the government to repeal/correct all un-Islamic provisions and practices. The government filed an appeal against this decision in the Supreme Court, the apex judicial body. After a long delay, the Supreme Court took up hearing of this and some other similar appeals in 1998. In addition to the complainants, the court invited and heard a large number of economists, bankers and *shari'ah* scholars both from Pakistan and abroad. It gave its judgment in 1999 in which it rejected the government's appeal and endorsed most of the sections of the Federal *Shari'ah* Court judgment. The court gave the government a timeframe ending in June 2001 to correct objectionable practices identified by the Federal *Shari'ah* Court and the Supreme court itself while hearing the case. Later on, in an appeal from the Government, the Court extended this deadline by one year. In compliance with that judgment, the government set up a Commission to devise a strategy for implementing the requirements of the judgment. The Commission submitted its report to the Government, but in the meanwhile one of the banks affected by the Supreme Court decision, filed a review petition. In 2002, the Court reversed its earlier decision and referred the case back to the Federal *Shari'ah* Court for a fresh hearing which has not yet begun. In the meantime, the Government has decided to follow a model of mixed systems whereby conventional and Islamic banking can function side by side.

2.2. Iran

A new banking law, "Law for Usury-Free Banking Operations", was enacted in Iran in August 1983 to replace interest based banking by interest free banking. The law required the banks to convert their deposits to an interest-free basis within one year, and their other operations within three years, from the date of the passing of the law, and specified the types of transactions that must constitute the basis for asset and liability acquisition by banks. The law also specified the responsibilities of the central bank under the new system and the mechanics of the central bank's control over the banking system.

The law allows banks to accept three types of deposits, viz., *qard al-hasanah* deposits, general term investment deposits and project-specific investment deposits. The *qard al-hasanah* deposits comprise of current as well as savings accounts which differ in their operational rules. The holders of current and savings accounts are guaranteed the safety of their principal amounts and are not entitled to any contractual return. However, banks are permitted to provide incentives to depositors through (i) grant of prizes in cash or kind,

(ii) reduction in or exemption from service charges or agent's fees payable to banks, and (iii) according priority in the use of banking facilities.

Holders of term investment deposits are entitled to receive a variable return, depending on the profitability of the bank's investments. The Central Bank fixes the minimum and maximum rates permissible. At the beginning of the year, "expected" rates of profit are declared. However, the banks are required to calculate the "actual" rates of return from their operations periodically and the difference between the "actual" and "expected" return is adjusted post facto. The law allows the banks to undertake and/or ensure the repayment of the principal amounts of term investment deposits.

The third type of deposit accounts is project specific in which banks mobilise savings for specific investment projects. In this type of account, the rate of return is calculated at the end of the project. The bank charges only an administrative fee for its intermediation between the savers and investors. The rest of the profit received by the bank is distributed among the deposit holders.

On the asset side, the law provides thirteen different modes of contract, through which finance can be provided. These are: (1) *Qard-al Hasanah*, (2) *Mudarabah,* (3) Civil Partnership (*Musharakah Madani*), (4) Legal Partnership (*Musharakah Haqooqi*), (5) Direct Investment, (6) Instalment Sales, (7) Hire-Purchase, (8) Forward Deals (*Salaf*), (9) *Ju'alah,* (10) *Muzara'ah*, (11) *Musa'qah,* (12) Debt Purchase, and (13) Guarantee Notes. However, in practice, instalment sale, civil partnership and *mudarabah* in trade activities are the most dominant modes of finance used.

One important feature of Islamic banking in Iran is that banks are obliged to earmark a portion of their resources for grant of *qard al-hasanah* to help achieve the socio-economic objectives set out in the constitution of the country. In addition to banks, a number of charity organisations have also been established under government patronage to grant *qard al-hasanah*. Besides *qard al-hasanah*, banks are authorised to extend financial assistance for productive ventures on profit/loss sharing basis in accordance with the principles of *mudarabah* and *musharakah*. Banks are allowed to provide part of the capital of a new joint stock company and also to purchase shares of existing joint stock companies. Banks are authorised to provide working capital financing to productive units by purchasing raw materials, spare parts and other items on their request for sale to them on the basis of deferred payment in instalments. Purchase of machinery and equipment for sale to their clients on a deferred payment basis is also allowed. Another mode is called *salaf* which is the same as *bay salam* and is used for meeting working capital requirements through advance purchase of output. Banks can engage in lease-purchase transactions. They can also provide finance on the basis of *ju'alah* (commission for working as an agent), *muzara'ah* (financing of agricultural production on a profit sharing basis, *musa'qah* (financing of orchard production on a profit sharing basis). In addition to these modes of financing, banks are

permitted to purchase debt instruments of less than one year maturity if these debts are issued against real assets.

Studies on the progress made in the implementation of the new system show that banks have, in general, adapted well to new procedures. Problems have been encountered, however, in moving away from traditional short term trade financing operations and toward profit sharing medium and long term financing operations. It was expected that with the passage of time banks would increase their involvement in *mudarabah* and *musharakah* financing but this expectation has not been fulfilled. No attempt has been made so far to Islamise the international banking and financial operations. Government continues to borrow from the banks on the basis of a fixed rate of return (Iqbal and Mirakhor, 1987, p.24). It has also been pointed out that some banking practices in Iran are at variance with the practice of Islamic banking in other countries (Mirakhor, 1988, p.55). A case in point is the treatment of investment deposits. In Iran, the law allows the nominal value of such deposits to be guaranteed, while such a guarantee is not considered compatible with Islamic teachings in other countries.

In Iran, the banking system has been used as an instrument of restructuring the economy, away from services and consumption towards production. Bank financing to the services sector has been drastically curtailed. Banks have reduced financing for the production of luxury goods and commodities with a large import content, while financial assistance for the production of necessities and intermediate goods has been appreciably increased. Financing facilities for the agricultural sector have been considerably expanded. The banking system has also been used as an instrument of income redistribution through the provision of *qard al-hasanah* loans to low income groups, financing the building of low cost houses, and provision of financing for small scale agro business and industrial cooperatives often without stringent collateral requirements.

2.3. Sudan

The process of the economy-wide Islamization of the banking system in Sudan has not been smooth and steady. The first attempt to Islamise the entire banking system was made in 1984 when a presidential decree was issued directing all commercial banks to stop interest-based dealings with immediate effect and to negotiate the conversion of their then existing interest-bearing deposits and advances into Islamically acceptable forms. Foreign transactions were temporarily allowed to continue, on the basis of interest. This sudden change forced the banks to adopt the nearest Islamic alternative available that is, *murabahah,* which soon constituted 90 per cent of their financial operations. The banks applied Islamic financing techniques only formally in their ledger books and in the reports submitted to the Central bank of the country. Policy makers in the Central bank were also discontented with the procedure of transforming the banking system. They considered it as a mere political

decision imposed by the government without having been preceded by adequate detailed studies. This experiment with economy-wide Islamization of the banking system came to an end in 1985 with the change in government. The Government revived the process in May 1990 by reactivating an existing Islamic banking law. It issued a more comprehensive law in 1992, which envisioned an economy-wide Islamization of the financial system including the government sector. Reports indicate that the effort is much more earnest and much better organised this time. Now all banks are using Islamic modes of finance. An important development worth mentioning is the attempt also being made to eliminate interest from the government. Other countries have found this a hard nut to crack. The government of Sudan has launched two Funds based on the principle of *musharakah* to mobilise resources for the public sector. The first is the Government Musharakah Certificate (GMC). It is an instrument that enables the government to raise funds through issuance of securities that promise the investor a negotiable return linked to developments in government revenue in return for their investment in the provision of general government services. The other is the Central Bank Musharakah Certificate (CMC). This is an equity-based instrument that is issued against the government (or Central bank) ownership in commercial banks. Under CMC, the Central bank becomes a partner with the investors in profits of the underlying assets. The distribution of profit between the Central bank and the investors is negotiable and the Certificate can be sold on the secondary market to another bank or the Central bank.

2.4. Bahrain

The Kingdom of Bahrain was amongst the first to recognise the importance of the concept of Islamic banking and finance and as a consequence has been both supportive of the development of the industry in general and welcoming to the new institutions in particular. Consequently, Bahrain has gathered a concentration of specialist Islamic institutions on its shores. The first Islamic bank in Bahrain was established in 1979, when the Bahrain Islamic Bank was licensed. Since then, the sector has grown considerably. Now Bahrain has the largest number of Islamic financial institutions, not only in the Gulf, but in the world. The Kingdom is playing host to 26 Islamic banks and financial institutions, five industry-support organisations, six Islamic insurance companies and 34 Islamic mutual funds. A comprehensive prudential set of regulations for Islamic banks was introduced in early 2000 by the Bahrain Monetary Agency (BMA). This is referred to as the Prudential Information and Regulatory Framework (PIRI). The framework covers areas such as capital adequacy, asset quality, and management of investment accounts, corporate governance and liquidity management.

Within such an environment, the Islamic financial industry in Bahrain will be able to enjoy sustainable growth based on strong investor and customer

confidence, attractive product design and expanding markets. Much is already in place. The Bahrain Monetary Agency's statutory responsibility as the sole regulator for the financial sector and the sector's adherence to the Prudential Information and Regulations for Islamic Banks (PIRI) framework ensures that Islamic institutions will continue to operate according to standards comparable to those of the conventional financial sector.

Product innovation continues apace. The Al-Salam Sukuk (a short-term security) and the *Ijara* Leasing Certificates are now firmly established and the Agency is fully committed to a rolling program of further issues as an integral part of the development of Bahrain as an international Islamic bond market. These initiatives have been matched on their part by the private sector. The introduction of an Islamic credit card, and research into *takaful*, are two outstanding examples of the degree of innovative thinking coming from the industry that is driving forward the parameters of Islamic banking and finance.

2.5. Malaysia

In Malaysia, separate Islamic legislation and conventional banking regulations exist side-by-side. The Islamic financial system that has developed in Malaysia over the last two decades is emerging as a comprehensive Islamic financial system that operates in parallel with, and is able to compete on an even keel with the more entrenched conventional financial system. The development of Islamic finance as an important niche activity in Malaysia's International Offshore Financial Centre in Labuan also complements the development of the domestic Islamic financial market.

The legal basis for the establishment of Islamic banks was the Islamic Banking Act (IBA) that came into effect on 7 April 1983. The IBA provides Bank Negara Malaysia (BNM) with powers to supervise and regulate Islamic banks, similar to the case of other licensed banks. The Government Investment Act 1983 was also enacted at the same time to empower the Government of Malaysia to issue Government Investment Certificates (GIC), which are government securities issued based on *shari'ah* principles. As the GIC are regarded as liquid assets, the Islamic banks can invest in the GIC to meet the prescribed liquidity requirements as well as to invest their surplus funds.

The first Islamic bank established in the country is the Bank Islam Malaysia Berhad (BIMB) which commenced operations on 1 July 1983. After about two decades of operations, BIMB has proved to be a viable banking institution with its activity expanding rapidly throughout the country with a network of 80 branches and 1,200 employees. The bank was listed on the Main Board of the Kuala Lumpur Stock Exchange on 17 January 1992. On 1 October 1999, a second Islamic bank, namely the Bank Muamalat Malaysia Berhad (BMMB) commenced operations. The establishment of the BMMB was the effect of the spin-off following the merger between the Bank Bu-

miputra Malaysia Berhad (BBMB) and the Bank of Commerce (Malaysia) Berhad (BOCB). Under the merger arrangement, the Islamic banking assets and liabilities of BBMB, BOCB and BBMB Kewangan Berhad (BBMBK) were transferred to BBMB, while the conventional operations of BBMB, BOCB and BBMBK were transferred to BOCB accordingly. In addition, BMMB was given 40 branches of BBMB and BBMBK in various locations throughout Malaysia.

As with any other banking system, an Islamic banking system requires three vital elements to qualify as a viable system i.e. a large number of players; a broad variety of instruments; and an Islamic money market, BNM has adopted a step-by-step approach to achieve the above objectives. The first step to spread the virtues of Islamic banking was to disseminate Islamic banking on a nationwide basis, with as many players as possible and to be able to reach all Malaysians. After careful consideration of the various factors, BNM decided to allow the existing banking institutions to offer Islamic banking services, using their existing infrastructure and branches. The option was seen as the most effective and efficient mode of increasing the number of institutions offering Islamic banking services at the lowest cost and within the shortest time frame. Following on from the above, on 4 March 1993, BNM introduced a scheme known as Skim Perbankan Tanpa Faedah (Interest-free Banking Scheme) or SPTF in short. More than 20 banks and investment companies are now offering Islamic banking services. The Malaysian Financial Sector Master Plan launched in 2001 is the blueprint for the development of the financial sector over a 10-year period in Malaysia. The plan, places importance on the development of Islamic banking and *takaful* sector as an important component in the financial system.

To ensure the sound and stable development of the Islamic financial industry, it needs to be supported by a strong regulatory and supervisory framework. To fulfil this requirement, the Islamic Financial Services Board (IFSB) was established in 2002. The IFSB is an international body hosted by Malaysia. It has the important mandate of developing the prudential standards in accordance with the unique features of the Islamic financial institutions.

3. Islamic Banks and Financial Institutions Working in Mixed Environment

3.1. Islamic Banks

There are now more than ninety Islamic banks and financial institutions working in the private sector, excluding those in Pakistan, Iran and Sudan where the entire banking sector is being Islamized. These institutions are spread in a number of countries and continents. The geographical distribution is given in the following table.

Table 1. – ISLAMIC FINANCIAL INSTITUTIONS BY REGIONS

Region	Number of Institutions	%
South and South East Asia	36	42.4
G.C.C.	19	22.4
Other M.E.[1]	13	15.3
Africa	9	10.6
Europe and America [2]	8	9.4
TOTAL	**85**	**100**

Notes: 1.Includes Turkey, 2. Most of these are not endogenous. They are registered there for tax and some other advantages

Source: Directory of Islamic Banks and Financial Institutions (1996), International Association of Islamic Banks, Jeddah.

These figures show that the largest number of Islamic financial institutions is in Asia followed by the Gulf Cooperation Council (GCC) and other Middle-Eastern countries. While this gives us an idea about the "spread" of Islamic banking, it does not obviously reflect the relative "strength" of Islamic banking in various regions. In order to see the relative "strength" of Islamic banking in various regions, the funds under management of Islamic banking and finance institutions in various regions are shown in the following table.

Table 2. – FUNDS MANAGED BY ISLAMIC INSTITUTIONS BY REGIONS

Region	Funds Managed (US dollars millions)	%
South and South East Asia	2,250.7	8.2
G.C.C.	17,834.5	64.7
Other M.E.	5,430.1	19.7
Africa	334.5	1.2
Europe & America	1,723.0	6.2
TOTAL	**27,573.0**	**100.0**

Source: Directory of Islamic Banks and Financial Institutions (1996), International Association of Islamic Banks, Jeddah.

It can now be seen that the bulk of the Islamic banking activity is concentrated in the Middle East, especially GCC countries. This region accounts for about 84 per cent of the total funds under management of Islamic banking and financial institutions.

3.2. Islamic Investment Funds

Islamic scholars have given a conditional approval to investment funds. What conditions must be satisfied before participating in equity funds is a subject that is being actively investigated at present. So far, Islamic scholars have prescribed three minimum requirements[2]: (i) the Fund must not deal in equities

of companies whose business activity is banned by the Islamic *shari'ah*; e.g. breweries, casinos conventional banks etc.; (ii) interest income earned by the Fund must be negligible and separable so that Fund's income can be cleansed of it; (iii) since sale of debt is not permissible except at face value, the proportion of debts receivable in the portfolio of the company should not exceed an "acceptable" proportion. How these conditions can be complied with in practice is discussed below in some detail.

To ensure that the companies selected for the investment are acceptable from the perspective of the *shari'ah*, a Fund management group can screen the prospective companies to be included in the portfolio. As with other types of ethical investment selection, both positive and negative criteria can be used. Negative criteria involves excluding companies whose major purpose is the production or distribution of alcohol or pork products or the management of gambling facilities or investment in *riba* based financial institutions. Some investors may prefer to avoid investing in airlines, hotels or supermarket chains, which serve alcohol, even though this is a minor part of their business.

Second, since, according to *shari'ah* principles both giving and taking interest is forbidden, ideally it would be desirable to avoid investing in companies which have any dealings with *riba* based banks, but practically, this would mean the exclusion of virtually all quoted companies, including those whose stocks are traded in the equity markets of Muslim countries. In practice, Fund management groups seeking to comply with the *shari'ah* adopt two criteria. First they examine the extent to which a company's income is derived from interest, any proportion in excess of 10 per cent being unacceptable. (In practice most Funds apply more stringent condition than this). The second criterion is to consider the extent of debt to equity finance, a proportion in excess of one third being unacceptable.

The s*hari'ah* law itself does not specify ratios such as those suggested by some scholars, nor does it establish what factors should be used in any calculations, such as debt to market capitalisation versus debt to book values. The latter is arguably more stable, as it is not subject to daily changes in market valuation, and there may be a case for using book values rather than market capitalisation as the appropriate screening variable.

It is worth emphasising that if all quoted companies that are leveraged are excluded, there would be nothing left to include in any investment portfolio. There are also the issues of any interest that quoted companies obtain on their bank balances. Information on such receipts should be available in the annual reports of any quoted company and in the interim statements. One possible solution to this problem is for the Fund Manager to pay an amount equivalent to the proportion of any dividends derived from interest to charity in order

[2] Some *shari'ah* scholars have laid down these conditions in their individual capacities or as members of *Shari'ah* Boards of Islamic Funds but as stated above the OIC fiqh Academy after deliberating this issue at several occasions has not issued a final ruling.

to purify the income. Alternatively the income may be distributed, but the *shari'ah* committee advising the Fund Manager may make a recommendation to the investor about the amount he or she should donate to an appropriate charitable cause. It is worth point out that any manager of a Fund designated as Islamic should be able to draw on the services of a *shari'ah* advisor, or even better have the opinion of a *shari'ah* committee charged with overseeing all operations of the Fund to ensure compliance with Islamic law.

Third, according to the majority of Islamic scholars, sale of debt is not permissible except at face value. Now most companies have accounts receivable in their portfolios i.e. debts. Can shares of these companies be bought and sold? Some shari'ah scholars have argued that the ruling of permissibility depends on what the dominant component is. If the ratio of debts receivable is less than 50 per cent in a company's portfolio, then buying and selling of its shares would be permissible.

Some Islamic investment funds were established in the early seventies. Many of them did not survive. The real growth in this sector has taken place in the last ten years. While definite information on the number of Islamic funds and their size is not available, it is estimated that there are more than 100 equity funds. If we also add other investment funds, e.g. commodity funds, lease funds, Trade funds etc. the number of Islamic investment funds would be in excess of 200. The movement for the establishment of equity funds really picked up during 1995-2000. During that period the number of funds increased from 25 to 98 and their assets grew from $750 million to approximately $5 billion. This growth was partly due to the launching of Islamic indices by the Dow Jones and FTSE.

However, in the last three years, as a result of the poor performance of stock markets worldwide, the industry has seen some decline. With better prospects for equity markets on the horizon, it is expected that the Islamic funds will again start growing in number and size. There are indications that it has already begun to happen.

4. Islamic Banking Practices By Conventional Banks

Another achievement of Islamic banking may be gauged from the fact that many conventional banks have also started using Islamic banking techniques in the conduct of their business, particularly in dealing either with Muslim clients or in dominantly Muslim regions. At present, the number of such conventional banks may not be very large, but the very fact that some very important and large multinational banks have also resorted to Islamic banking is itself a pointer of much significance. A Western observer of Islamic banking has very aptly remarked that "it is an excellent reflection on the success of

Islamic banking that many conventional commercial banks are now offering their clients Islamic financial services" (Wilson, R. 1990b).

The involvement of some Western conventional banks, particularly multinational banks, in Islamic banking started quite early, in the eighties. In the early period of their establishment, Islamic banks were stuck with high liquidity which was the result of high growth of deposits and very few investment opportunities. In such a situation, Islamic banks turned to Western institutions such as Citibank to find profitable avenues for the investment of their money. Most of the resources supplied by the Islamic banks went to commodity trade and trade finance deals. Since Islamic banks did not want any involvement of these funds with *riba*-based transactions, the Western banks found themselves negotiating "*murabahah*" deals in which they arranged with a trader to buy goods on behalf of the Islamic bank and resell them at a mark-up. This prompted other Western commercial banks to follow the suite. ("The West Embraces Islamic Banking", The Financial Times, October 7, 1994).

Although it is difficult to know with certainty how many conventional commercial banks around the globe practise Islamic banking techniques, even a randomly selected short list may contain some of the giants of the international banking industry such as Chase Manhattan, The Citibank Bank, the ANZ Grindlays, the Kleinwort Benson along with other banks such as the Union Bank of Switzerland, Girozentale of Australia, the ABC International, the Arab Banking Corporation, the National Bank of Kuwait, the Saudi British Bank, the National Commercial Bank and the Riyadh Bank of Saudi Arabia and Bank Misr. In addition to these banks, multinational banks located in certain Islamic countries such as Iran and Sudan also conduct their activities in accordance with the principles of Islamic banking because the local laws require them to do so.

5. International islamic Financial institutions

Some International Financial Institutions have also come onto the scene. Two major international holding companies, namely, the Dar al-Mal al-Islami and the Al-Baraka Group each control more than a dozen Islamic banks and finance companies. An International Council of Islamic Banks has also been formed. But perhaps the most important multinational institution is the Islamic Development Bank. Some details about this institution are given in section 5.1 while some other international financial institutions, which have been recently established with the active involvement and support of Islamic Development Bank, are mentioned in Section 5.2.

5.1. Islamic Development Bank

The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities, individually and collectively, in accordance with the principles of the *shari'ah.*

The authorised capital of the Bank currently stands at 15 billion Islamic Dinars[3] (ID) (USD 18.82 billion). Its subscribed capital amounts to 8.1 billion Islamic Dinars (USD 10.16 billion), whereas its paid-up capital amounts to Islamic Dinars 2.6 billion (USD 3.3 billion). The ordinary resources of the Bank consist of members' subscriptions (paid-up capital, reserves and retained profits), which amounted to Islamic Dinars 3.77 billion (USD 4.73 billion) at the end of March 2002.

Unlike other financial institutions, the Bank does not support its financial resources by borrowing funds from conventional financial markets, as this involves the payment of interest. For this reason, the Bank has developed new *shari'ah*-compliant financial schemes and instruments to support its ordinary financial resources. These schemes and instruments include the IDB Unit Investment Fund (IDB UIF) the Export Financing Scheme (EFS), which was known formerly as the Longer-term Trade Financing Scheme (LTTF) and the Islamic Banks' Portfolio (IBP). The Bank has so far raised about USD 708 through these schemes. In a major move in 2003, the Bank launched its debut *sukuk* issue (assets-based bond) worth USD 300 million. The issue proved to be an overwhelming success and closed at USD400 million.

IDB extends financial support to the development projects of member countries. Unlike other multilateral financial institutions, the Bank finances its operations through a number of Islamic financing modes. They include interest-free loans; equity participation; leasing; instalment sale; profit sharing etc.

5.2. Other International Islamic Financial Institutions

5.2.1. The Accounting and Auditing Organisation for Islamic Financial Institutions

The shareholders, depositors, investors and regulators utilise the information provided in the financial statements. If all these statements are prepared on the basis of uniform standards, it facilitates objective comparison between different financial institutions and enables the market discipline to work more effectively. In this regard, the Accounting and Auditing Organisation for the Islamic Financial Institutions (AAOIFI) has already done a valuable job in adapting the international standards to suit the Islamic financial institutions. The AAOIFI standards were introduced for the first time in 1993 for Islamic financial institutions. The Islamic financial institutions are adopting these standards in increasing numbers.

5.2.2. The General Council of Islamic Banks and Financial Institutions (GCIBFI)

The understanding of Islamic banking and finance has grown rapidly during the past three decades. Nevertheless, being relatively new, it is important

[3] The Islamic Dinar is considered as the IDB accounting unit; it is equivalent in value to one Special Drawing Right (SDR) of the International Monetary Fund (IMF).

for the industry to develop strategic alliances and partnerships in order to remove any misconceptions and to pool together resources to confront the challenges. The GCIBFI with its headquarters in Bahrain has been established with such a background and objective.

5.2.3. International Islamic Financial Market (IIFM)

At present, the Islamic financial services industry faces greater liquidity risk due to the absence of a secondary market for Islamic financial instruments. The non-existence of an inter-bank Islamic money market makes liquidity management a challenging task. The Islamic banks are thus under constraint to maintain liquidity that is higher than that which conventional banks do. This adversely affects the Islamic banks' competitiveness. The establishment of an IIFM is thus one of the most important building blocks for the Islamic financial services infrastructure. To this end a Working Group was constituted, comprising of the Labuan Offshore Financial Services Authority (LOFSA), the Bahrain Monetary Agency (BMA), the Bank of Sudan, the Bank of Indonesia, and the IDB. The agreement on establishing the IIFM Board was signed in Paris on 13th November 2001 and it became operational in 2002 in Bahrain.

5.2.4. The Islamic Financial Services Board (IFSB)

Proper regulation and supervision of banks and financial institutions is also important for financial efficiency and stability. Some of the risks faced by the Islamic financial industry are unique due to the *shari'ah* compliance requirements. Bank supervisors utilising the traditional standards cannot assess such risks. The need for special guidelines for the regulation and supervision of Islamic banks has long been felt. Some regulatory authorities have already introduced guidelines for Islamic banking supervision in their respective jurisdictions. With an active involvement of the International Monetary Fund (IMF), the IDB and support of the Bahrain Monetary Agency (BMA), Bank Negara Malaysia (BNM) and other central banks, an Islamic Financial Services Board has recently been established. It became operational in Malaysia in November 2002.

5.2.5. The International Islamic Rating Agency (IIRA)

Market discipline is important for an efficient and stable financial system. In this regard, external rating systems and accounting standards play a vital role in improving the availability of information to depositors, bankers and regulators. Existing conventional rating systems are primarily concerned with the financial strength of counterparties and ignore compliance with the *shari'ah* requirements. Since non-compliance of even a financially sound Islamic bank

with the *shari'ah* requirements can be a serious cause of systemic instability, the need for an Islamic rating agency has always been felt. Keeping this need in view, an International Islamic Rating Agency (IIRA) was incorporated in Bahrain in 2002. The IIRA will also scrutinise *shari'ah* aspects of financial institutions and products, which will be of major importance to the Islamic financial industry, bearing in mind the global character/appeal of the agency. In this respect, the IIRA as a specialised rating agency will be complementary to the existing agencies, adding value to the market. By assessing fiduciary relationships and credit risk inherent in any instrument or issuer, the IIRA will help create a higher degree of confidence and acceptability of products among the players in the industry. Therefore, IIRA operations will be broader than those of conventional rating agencies.

6. Islamic and conventional banks: a comparative analysis

In this section the performance of Islamic banks has been evaluated *vis-à-vis* conventional banks. For this purpose, a sample of 12 conventional banks was chosen to serve as a 'Control Group' for comparative analysis. Since the data for these banks has been taken from a secondary source, *The Banker's Almanac*, the data were not as detailed as in the case of Islamic banks. Therefore, only some major variables, for which data for both groups was available, will be analysed.

6.1. Growth Analysis

The rates of growth for four important variables are shown in Table 3.

Table 3. – Comparative Annual Growth Rates (%)

	Total Equity		Total Deposits		Total Investments		Total Assets	
	Islamic Banks	Conventional Banks	Islamic Banks	Conventional Banks	Islamic Banks	Conventional Banks	Islamic Banks	Conventional Banks
1990-94	7.9	6.4	9.3	3.1	11.3	-0.8	9.3	4.8
1994-97	10.5	4.7	6.1	7.2	7.3	9.1	6.8	6.6
1990-97	9.0	5.6	7.9	4.8	9.6	3.3	8.2	5.6

Source: Calculated by author. Basic data for Islamic banks compiled from their Annual Reports and for conventional banks from the *Banker's Almanac*.

It may be noted that in the case of all the variables, the rates of growth achieved by Islamic banks are higher than the conventional banks in the control group during 1990-94 as well as for the 1990s as a whole.

The rate of growth of total equity for the entire period was 9 per cent per annum in the case of Islamic banks as against 5.6 per cent for the control group. The rate of growth of total deposits in the case of control group banks was 3.1 per cent per annum during 1990-94, whereas the same rate was 9.3 per cent

in the case of Islamic banks. However, the rate of growth in deposits declined to 6.1 per cent in the case of Islamic banks for the second period and that of conventional banks increased to 7.2 per cent in the same period, partly reversing the increasing market share of Islamic banks during 1990-94.

A similar trend is observed in the case of total investments, which grew at a handsome rate of 11.3 per cent during 1990-94 in the case of Islamic banks while the control group banks witnessed a negative rate of growth. During the second period, growth in investment in the case of Islamic banks declined to 7.3 per cent while in the case of conventional banks it increased to 9.1 per cent, surpassing the growth rate of Islamic banks.

In the case of total assets, Islamic banks posted a higher rate of growth in both periods. During 1990-94 it was 9.3 per cent as against 4.8 per cent, while during 1994-97 it was 6.8 per cent as against 6.6 per cent for conventional banks.

6.2. Ratio Analysis

Some of the key ratios used in the balance sheet analysis have been computed for both groups and are reported in Table 4.

Table 4. – COMPARATIVE RATIOS (%)

Ratios	1990-94		1994-97		1990-97	
	Islamic Banks	Conventional Banks	Islamic Banks	Conventional Banks	Islamic Banks	Conventional Banks
Capital Asset Ratio	9.3	9.0	10.0	9.0	9.6	9.0
Liquidity Ratio	20.2	27.7	15.7	39.3	18.5	31.9
Deployment Ratio	92.2	75.8	96.0	69.0	93.7	73.3
Cost/ Income Ratio	55.9	NA	52.4	60.3	55.4	NA
ROA	1.9	NA	2.3	1.4	2.0	NA
ROE	19.9	NA	22.6	15.0	21.2	NA

Source: Calculated by the author. Basic data for Islamic banks compiled from their Annual Reports and for conventional banks from the *Banker's Almanac*.

The first of these ratios is the capital asset ratio, which measures the strength of the banks. The weighted average capital asset ratio for Islamic banks for the 1990-97 period amounts to 9.6 per cent while this ratio for the same period was 9.0 per cent in the case of conventional banks. There has been virtually no change in this ratio for the entire period in the case of conventional banks, whilst in the case of Islamic banks the ratio increased from 9.3 per cent in the first period to 10.4 in the second period.

With regard to liquidity, the comparative analysis given below allows us to conclusively reject the hypothesis that Islamic banks are suffering from excess liquidity. The liquidity ratio calculated as the ratio of liquid assets to total

deposits (including *mudarabah* funds in the case of Islamic banks) is, in fact, lower for Islamic banks as compared to the control group banks. This ratio for the whole period was 18.5 per cent in the case of Islamic banks as against 31.9 per cent for the control group.

Islamic banks have also made better use of their resources. It can be seen that the deployment ratio is higher for the Islamic banks compared to the conventional banks.

Also in terms of cost effectiveness, the Islamic banks as a group, perform better than conventional banks; the cost to income ratio being 52.4 per cent for Islamic banks as against 60.3 per cent for conventional banks. However, the ratio for Islamic banks is unduly pushed down because of the high weightage of Al-Rajhi for whom the ratio is very low due to no financing costs, as the bank relies heavily on demand deposits not carrying any rate of return.

The profitability ratios are available for only one period, i.e. 1994-97 for the control group. During this period, both ROA and ROE for Islamic banks are substantially higher than conventional banks. The two ratios are respectively 2.3 and 22.6 per cent for Islamic banks as against 1.35 and 15 per cent for the control group.

7. Summary and Conclusions

Islamic banking, like any other banking system, must be viewed as an evolving system. No one disputes that there is a definite desire amongst Muslim savers to invest their savings in ways that are permitted by the *sharī[ah.* Nevertheless, they must be provided with *halāl* returns on their investments. Islamic scholars and practical bankers took up that challenge and have made commendable progress in the last twenty-five years in providing a number of such instruments. However, the concepts of Islamic banking and finance are still in their early stages of development and Islamic banking is an evolving reality for continuously testing and refining those concepts.

Islamic banking and financial institutions have now spread across several Muslim countries. Some non-Muslim countries and/or institutions are also keen to experiment with Islamic financial techniques. Various components of the Islamic financial system are now available in different parts of the world in varying depth and quality. A detailed and integrated system of Islamic banking and finance is gradually evolving.

Theoretical arguments and models developed by Islamic economists and the successful practice of hundreds of institutions in heterogeneous conditions both testify to the viability of Islamic banking. The average growth rate of deposits in Islamic banks over the past twenty years has been over ten per cent per annum. Many studies testify to the great success of Islamic banks in mobilising resources. Another manifestation of the success of Islamic bank-

ing is the fact that many conventional banks have also started using Islamic banking techniques in the conduct of their business, particularly in dealing either with Muslim clients or in predominantly Muslim regions.

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An Assessment of the Performance of Islamic Mutual Funds*

Abstract

Being in the market for less than a decade, Islamic mutual funds, governed by *Shari'ah* (the Islamic Law), are one of the latest and fastest growing products of contemporary Islamic finance. Using a sample of 46 Islamic mutual funds classified into eight sector-based categories, the performance of each fund and fund category is measured and compared to the performance of two market benchmarks, an Islamic index and a conventional one. Our findings suggest that the behaviour of Islamic mutual funds does not differ from that of other conventional funds, with some *Shari'ah*-compliant mutual funds over-performing their benchmarks and others under-performing. Hence, conventional investors may include Islamic mutual funds in their portfolio collection. Of course, the onus is always on the investor to choose a good performing mutual fund, regardless of whether it is a conventional fund, Islamic fund, or ethical fund. Another major observation is the strong performance of Islamic mutual funds compared to the benchmarks during the recession period. This pattern may be explained by the improving management skills of these newly created funds, or that these funds perform better during a recessionary period, thus making them more useful as a hedging tool for both conventional and Muslim investors.

1. Introduction

Islam is a religion that unites both the spiritual and temporal aspects of life. It regulates not only an individual's relationship with God, but also human relationships in social and financial settings. Thus, the Shari'ah, or the Islamic Law, is part of every Muslim's cultural, social and behavioural identity.

The application of Shari'ah to investment choices and management is not a new phenomenon. Earlier Muslims were able to establish an interest-free financial system for mobilising resources to finance productive activities and consumer needs. The system had worked quite effectively for centuries, but it was gradually replaced by the interest-based system during recent times. The contemporary increasing desire of Muslims to bring their modern economic and financial activity to conform to their cherished religious values

* The authors are grateful to the participants of the International Banking Conference on "From Money Lenders to Bankers: Evolution of Islamic Banking in relation to Judeo-Christian and Oriental Banking Traditions", held in Prato, Italy, September 9-10, 2003. All remaining errors are those of the authors.

and beliefs has led to a growing interest in Islamically-approved Investment vehicles.

The wider acceptance of equity investments by Shari'ah scholars in the early 1990s paved the way to launch mutual funds that operate in compliance with the ethical guidelines of the Islamic Law (hereafter, in this paper, this will be called Islamic mutual funds). According to the London-based Institute of Islamic Banking and Insurance, there are over 250 Islamic institutions in some 75 countries that are managing funds worth over USD 200 billion. In the early 1990s, many *Shari'ah*-compliant mutual funds began to appear. There are now approximately 126 funds with roughly USD 4 billion in assets under management. Other than being a *halal* (Islamically-acceptable) investment alternative available for Muslim investors, the funds also respond to the specific need for more liquid investment tools.

Further, the establishment of credible equity benchmarks by the Dow Jones Islamic Market Index (DJMI) and FTSE Global Islamic Index Series, followed by the Malaysian Kuala Lumpur Syariah Index, has been a turning point for the industry, giving both Islamic and conventional investors something with which to compare.

Despite the increasing attention of practitioners on Islamic mutual funds, there has not yet been, to the authors' knowledge, any research concerning the performance of these funds and how they fare in comparison with conventional funds. This study aims at assessing the performance of the Islamic mutual funds and examining whether there exists any significant reward or penalty for investing in them.

Using a sample of 46 Islamic mutual funds classified into eight sector-based categories, the performance of each fund and fund category is measured and compared to the performance of two market benchmarks – an Islamic index and a conventional one. Our findings suggest that the behaviour of Islamic mutual funds does not differ from that of other conventional funds, with some *Shari'ah*-compliant mutual funds over-performing their benchmarks and others under-performing. Another major observation is the strong performance of Islamic mutual funds compared to both benchmarks during the recession period. One possible explanation of this pattern is that these funds' performance is improving with time, as fund managers are gaining more experience and a better sense of the market. Another possible implication is that Islamic mutual funds might be a good equity hedging investment during market downturns. Therefore, the major conclusion of this paper is that conventional investors can consider Islamic mutual funds in their portfolio collection, especially during slow market periods; yet, the onus remains on the investor to screen out various candidate mutual funds according to their performance, regardless of whether the fund is a conventional one, or Islamic, or ethical, etc.

This paper is organised as follows. Section II sheds some light on the background and guidelines governing Islamic mutual funds. Section III presents a summary of related academic literature. Section IV outlines the sources of sampled data and treatment, along with the proposed hypotheses. Section V details the results of various performance measures used to compare Islamic mutual funds and conventional funds. Finally, chapter VI summarises the major conclusions of this paper.

2. Islamic Mutual Funds: Background and Guidelines

An Islamic mutual fund is similar to a "conventional" mutual fund in many ways; however, unlike its "conventional" counterpart, an Islamic mutual fund must conform to the *Shari'a*h (Islamic law) investment precepts. The Shari'ah encourages the use of profit sharing and partnership schemes and forbids riba (interest), maysir (gambling and pure games of chance), and gharar (selling something that is not owned or that cannot be described in accurate detail; i.e., in terms of type, size, and amount) (El-Gamal 2000).

The Shari'ah governs several aspects of an Islamic mutual fund, including its structure (Shari'ah Supervisory Board), asset allocation (portfolio screening), investment and trading practices, and income distribution (purification). The Shari'ah board, made up of a team of prominent Islamic legal scholars, represents the salient feature that distinguishes Islamic mutual funds from their conventional counterparts. It assumes the responsibility for auditing the Shari'ah compliance of a fund, including its components and management. It functions as a customer advocate representing the religious interest of the investor (DeLorenzo, 2000).

When selecting investments within their portfolio (asset allocation), an Islamic mutual fund must set up screens in order to select only those companies that meet its qualitative and quantitative criteria set by the Shari'ah guidelines. Qualitative screens are used to filter out companies based on the nature of their business (e.g., firms producing or selling alcohol and biotechnology firms using aborted embryos and human cloning), or securities that contain one of the Shari'ah prohibited elements such as riba, maysir or gharar, as explained earlier. Thus excluded are fixed income instruments such as corporate bonds, treasury bonds and bills, certificates of deposit (CDs), preferred stocks and warrants, futures and options, forwards, etc. Moreover, Islamic mutual funds cannot trade on margin; in other words, they cannot use interest-paying debt to finance their investments. It is also not permissible to engage in sale and repurchase agreements (i.e. ***repos*** or buy-backs). These transactions are considered akin to indirect interest charges.

On another front, one of the essential conditions, based on which contemporary scholars allow investment in stocks of companies with tolerable amount of interest income or with tolerable revenues from unacceptable business ac-

tivities, is that all "impure" earnings should be "cleansed" by giving them away to charity. If, for example, the company has 8 per cent interest-related income, then 8 per cent of every dividend payment must be given away to "purify" the fund earnings. Cleansing capital gains, however, remains debatable as some scholars argue this is not necessary since the change in the stock price does not really reflect interest, while others suggest that it is safer and more equitable to purify earnings made from selling shares as well (Usmani, 2002). This purification process is done either by the fund manager before any distribution of income, or by reporting the necessary financial ratios for investors to purify their earnings themselves.

Another form of purification is Zakah. Zakah is a form of charity paid on personal wealth (exceeding a minimum amount called *nisa*b) held idle for one lunar year. The rate of *zakah* differs depending on the type of asset with 2.5 per cent being the rate on most forms of monetary wealth and earned income (Al-Qaradawi, 1999). Zakah calculation on investment profits, however, is still controversial (DeLorenzo, 2002).

The Islamic mutual funds market is one of the fastest growing sectors within the Islamic financial system. Yet, when compared to the mutual fund industry at large, Islamic mutual funds are still at the infancy stage of growth and development, most having been around for less than a decade. Islamic funds are pretty diverse for a young industry. While the majority of the funds are equity funds (84 per cent of the total 126 funds), balanced (*or secured funds*) (14 per cent) as well as Islamic bond *(Suku*k) funds (2 per cent) have recently been launched. Moreover, among the equity funds, several sectors and geographical investment areas are featured. Out of the total 126 available Islamic funds, 35 are Global equity funds (28 per cent), 10 are American equity funds (8 per cent), 5 are European equity funds (4 per cent), 5 are Asian equity funds (4 per cent), 29 are Malaysian equity funds (23 per cent), 13 are country funds – mostly Saudi Arabian, Egyptian and South African (10 per cent) - and 8 are Technology and small cap equity funds (6 per cent).

Islamic equity funds have experienced excellent growth during the late 1990s as they benefited from the technology boom, most of them demonstrating high positive returns, even higher than their benchmarks. Their number increased from 8 funds prior to 1992, to 95 funds with about USD 5 billion in assets in 2000, then dropped to about USD4 billion by the end of 2001. Nevertheless, more funds continued to be launched in 2002 and 2003, with brighter market expectations and more lessons being learned.

The drop in the industry's total assets that occurred in 2000-2001 can be attributed to the decline of world equity markets and investors' flights to safety. Islamic equity fund managers reacted accordingly by rebalancing their portfolios, with the overweight in technology being shifted to the healthcare and energy sectors. In addition, the new funds coming on to the market tended to be more capital-protected or balanced funds. Of the 23 funds launched in

2000, nine were global equity funds and five were capital protected or balanced funds; whereas, of the 20 funds launched in 2001, five were capital protected or balanced and only three were global equity funds. However, other funds were closed or liquidated in the same year.

According to an analysis made by Failaka Inc. (2002), the 15 most successful Islamic funds have been those that have solid retail distribution channels, such as the National Commercial Bank and Al-Rajhi Bank in Saudi Arabia and Permal Asset Management, based in New York. Further analysis of successful funds shows that they charge low or no up-front sales charge (load), their annual management fees are around the industry average, and their minimum investment thresholds are low enough to attract the retail investor. The average fund size of this group is USD 108.2 million (median = USD 53.4 million), with the largest fund being Al-Ahli Global Trading of NCB (USD 503 M). On the other hand, of the bottom 15 funds in terms of assets, three have minimum investment thresholds of over USD 25,000. Nine charge an up-front load, six of which are 5 per cent or more. Six of these funds have annual management fees of 2 per cent or more. The average funds size of this group is USD 4.4 million (median = USD5.0 million).

The acceptability of common stock screening guidelines by the vast majority of Shari'ah scholars has not translated into a rush for Islamic funds. One reason is that Islamic funds have not fared well in marketing and in differentiating themselves from their conventional counterparts. Moreover, some Muslim investors fear that there remain some haram (Islamically forbidden) elements in them. They prefer to place their money in Islamic banks and institutions that 'truly' invest in Islamically-acceptable products offered by Islamic companies in Muslim countries. Such products include Ijarah (Leasing), Istina'a (Working Capital Financing, Construction, etc.), Murabaha (Trade Finance), and Mudaraba (Equities, Real Estate, Commodities).

In brief, Islamic mutual funds offer Muslim investors the dual benefits of a mutual fund's investment and compliance with Islamic guidelines. What remains is to empirically assess the historical performance of these funds, and check whether, by complying with ethical and religious guidelines, any significant risk-adjusted returns are being sacrificed.

3. Literature Review

Earlier mutual fund performance literature did not tackle the performance of the Islamic mutual funds industry. One exception is Hajara Atta's (2000) study, which suggests that the Islamic index outperforms a sample of unscreened ethical benchmark using Sharpe, Treynor and the unconditional Jensen measure.

The closest alternative to evaluating Islamic funds in the literature is to study the performance of ethical funds. Luther, Matatko and Corner (1992) pro-

vide weak evidence that the UK ethical funds outperform two market indices. Since the ethical funds tend to invest a larger part of the funds in smaller companies with lower dividend yields, Luther and Matatko (1994) deem it appropriate to introduce a small company index as the market proxy. The reported findings demonstrate that ethical funds perform much better when evaluated against a small company benchmark, than when only the Financial Times All Share index (FTSA) is used. Kreander *et al.* (2000) extend this analysis to consider European funds from a small number of countries. They find that European ethical funds perform at least as well in the Morgan Stanley Capital International (MSCI) World Index. When Swedish ethical funds are evaluated against a Swedish benchmark, their performance is outstanding, while it is much more modest when compared to a global index.

The study by Mallin, Saadouni and Briston (1995) overcomes the benchmark problem of the early studies by using a matched-pair analysis. They study the returns earned by 29 UK ethical funds and 29 UK non-ethical funds, matched on the basis of age and size, between 1986-1993, using the Jensen, Sharpe and Treynor performance measures. A small majority of funds from both groups under-perform the market, as measured by the FTSA index. In addition, ethical funds tend to outperform, relative to their matched non-ethical pairs, although this effect is weak.

A more recent study of UK ethical fund performance by Gregory, Matatko and Luther (1997) adopts a matched-pair approach, and employs a size-adjusted measure of performance. Their study concludes that there is no significant difference between the returns earned by the ethical and non-ethical funds, and that both groups under-perform the FTSA benchmark index. However, the age of a fund appears to be an important factor influencing each fund's alpha measure, whereas the size of a fund and its ethical status are found to be insignificant.

The UK results mirror the findings of studies that analyse the performance of US ethical funds. For example, using monthly data from 1994 to 1997, M'Zali and Turcotte (1998) compare the performance of 18 American and Canadian ethical funds with 10 non-ethical funds, where both groups are managed by the same investment groups. They employ the Sharpe and Treynor measures to assess fund performance and demonstrate that four of the ethical funds outperform the market index. However, the majority of funds under-perform the Standard & Poor's S&P 500 Index and the Toronto Stock Exchange TSE 300 Index.

Hamilton, Jo and Statman (1993) compare the performance of a sample of 32 American ethical funds to that of 170 ordinary funds over a ten-year period (1981-1990). The average return for the ethical funds is found to be higher than the average returns for the "ordinary," suggesting that investors do not lose by investing in similar ethical funds. The same finding is later confirmed by Reyes and Grieb (1998).

In summary, while the results of testing ethical funds are inconclusive, it appears that there is no significant penalty for investing in ethical funds compared to conventional funds.

4. Data Description and Methodology

4.1. Data Sources

Sources of data about Islamic mutual funds are still very limited compared to their ethical or conventional counterparts. Failaka International Inc. (www.failaka.com), established in Chicago in 1996, is the first specialised organisation to monitor and publish performance data on Islamic equity funds. In addition to customised research and consulting services offered by Failaka, the company publishes on its website, periodic lists of all known Islamic mutual funds, yearly performance reports on almost half of the existing funds, periodic analysis of the industry, and information about each fund and performance graphs showing the percentage change of the fund's monthly NAVs and its relative market proxy over a given year. Failaka, however, has no historical data or rating on these funds.

Failaka's list of August 2002 includes the names of 106 Islamic mutual funds. Those funds were directly contacted for historical NAVs or returns since their fund's inception date, and 37 of them responded. On a parallel track, Standard and Poor's (www.sp-funds.com) provided historical data on 48 Islamic mutual funds, ten of which are also available through Failaka; thus, the total number of funds for which monthly data are available, is 75. Next, one restriction that is used in funds selection is the availability of the fund's monthly returns over a period of no less than two years, resulting in a final sample of 46 Islamic mutual funds. The median age of the whole sample is only 2.5 years for the 75 gathered funds and 3.25 years.

Funds are then classified into eight categories according to their regional or sector investment exposure. These are: Global equity funds, American equity funds, European equity funds, Asian equity funds, Malaysian equity funds, Emerging markets equity funds, Emerging markets-South Africa and Small Cap/Technology funds. This classification gives further insight into sector performance. Two other categories, the Balanced (or Secured funds) and the Islamic bond funds, are not represented in the study due to the fact that they were launched after 2000 when the equity market began its decline.

The period covered in the study begins on January 1, 1997, and ends on August 31, 2002. The January 1, 1997 date is chosen since a relatively good number of funds became available in the market around that time. One feature of this period is that it covers a boom phase from 1997 until early 2000 and a recessionary phase beginning in the year 2000. Hence, the total 68-month sampling period is further divided into two equal sub-periods – the

first 34 months ending on October 31, 1999, and the remaining 34 months to reflect the booming-slowing sub-periods.

Two stock market indices are used as benchmarks in the study to evaluate the performance of the Islamic funds and the fund categories: an Islamic market index (representing region or sector specific index), and a conventional broad market index. With regard to the general market index, the Standard & Poor's S&P 500 Composite Price Index is used as the acceptable proxy for the studied funds and funds' categories. The monthly NAVs for the S&P 500 are gathered for the entire study period from January 1, 1997 till August 31, 2002. The three-month U.S. treasury bills are used in the study as a risk-free asset. Their relative monthly annual yields are gathered from the U.S. Federal Reserve website (www.federalreserve.org) over the entire study period.

With regard to Islamic-based indices, we have considered the FTSE Islamic Index Series and the Dow Jones Islamic market index. Both the FTSE and Dow Jones screen out stocks, the core activities of which are not permitted by Shari'ah. The FTSE has five indices, the global Islamic index and four regional (the Americas, Europe, Pacific Basin and South Africa) with data available from 1994. However, the FTSE series does not have a sector index. The Dow Jones has regional Islamic market indices covering the United States, Europe, Asia/Pacific, Canada, and the United Kingdom. In addition to its geographical indices, the Dow Jones has Islamic indices for technology stocks and extra liquid securities.

It is arguably appropriate to use the FTSE and Dow Jones indices to compare the performance of dollar-denominated Islamic global equity funds, but they may not be as relevant when evaluating the performance of equity markets in Muslim countries, where country specific indices can be more relevant, if available. Yet, not all Muslim countries provide such indices. Thus, we use a list of the Islamic indices that correspond as closely as possible to each fund category. For instance, we use five FTSE indices (global, America, Europe, Pacific Basin, and South Africa) as benchmarks to match their corresponding sector categories in our sample of Islamic mutual funds categories (global, America, Europe, Asian, and Emerging markets-South Africa, respectively). The Dow Jones technology index is used as the benchmark for our sample of small cap funds. The Kuala Lumpur Stock Exchange Syariah Index from April 1999 and the FTSE Pacific Basin Islamic Index are used for the period prior to that as the benchmark for the Malaysian funds. Finally, since the Emerging markets have no specific country Islamic index, the FTSE Global Islamic Index is used as the benchmark for funds in this category.

4.2. Methodology

The total monthly (NAV-based) returns for each single fund and fund category are calculated, as well as the returns of the S&P 500 Index (as proxy for conventional funds) and the five FTSE Islamic Indices (Global, Americas,

Europe, Pacific Basin, and South Africa) and the Dow Jones Islamic Technology Index (as proxy for Islamic funds benchmark). In addition, mean portfolio returns, standard deviations and betas for each portfolio are also calculated.[1]

Sharpe measures, Treynor measures, Jensen measures, Fama measures (covering return on overall performance, return premium when fully diversified, reward for the lack of diversification, and return on net selectivity), and the Transformed Sharpe Measures introduced by Jobson and Korkie (1981) are used to measure the performance of each portfolio and compare it to its benchmark. A One-way ANOVA Test is also used to test the hypothesis of means equality and another test for identifying the cause and direction of the difference in means, if any, are conducted.

The Sharpe ratio represents the portfolio excess return per unit of total risk, and the higher this ratio above the benchmark, the better it is. The Sharpe ratio is calculated as follows:

$$\text{Sharpe} = (R_p - R_F) / \sigma \quad (1)$$

The Treynor ratio is equal to the portfolio excess return per unit of systematic risk (beta), and the higher this ratio above the benchmark, the better is. The Treynor ratio is calculated as follows:

$$\text{Treynor} = (R_p - R_F) / \beta \quad (2)$$

Jensen's alpha measures excess returns, if any, above (or below) the fund risk-adjusted return as expected in a CAPM world. A positive (negative) alpha implies that the portfolio is outperforming (under-performing) its market premium benchmark, whilst a (statistically) zero alpha means that the portfolio performance is normal, as expected in a CAPM setting. Jensen's alpha is estimated using the following regression model:

$$(R_p - R_F) = \alpha + \beta\,(R_M - R_F) \quad (3)$$

Fama (1972) integrates the work of Sharpe, Treynor and Jensen. Using the security market line (SML) model, the Fama measure divides the overall portfolio return into three components: return premium when fully diversified, reward for the lack of diversification, and return on net selectivity. Portfolio returns $\overline{R}_p$ is equal to:

$$\overline{R}_p = R_F + [E(R_p) - RF] + [E(R_p^*) - E(R_p)] + [\overline{R}_p - E(R_p^*)] \quad (4)$$

where, $\overline{R}_p$ is the actual return from portfolio P (measured ex-post), $E(R_p)$ is the expected return from portfolio P in a CAPM world, and $E(R_p^*)$ is the CAPM expected rate of return for a targeted beta (i.e., $E(R_p^*) = R_F + \beta_T\,(R_M - R_F)$. In this context, $[E(R_p) - RF]$ is the premium earned on a portfolio that is fully diversified, $[E(R_p^*) - E(R_p)]$ is the reward for lack of diversification, and

[1] When estimating beta, the normality of the data is an essential assumption for the ordinary least, and is therefore tested for.

$[\overline{R}_p - E(R_p^*)]$ is the return on net selectivity (i.e., the ability to select assets so that beta of the portfolio is the one that is theoretically implied for it).

Fama argues that it is difficult to achieve perfect diversification; therefore, investors should be rewarded for the lack of diversification. Also, additional net selectivity should be compensated for. Hence, in a world of imperfect diversification, Fama measure is superior to Sharpe, Treynor and Jensen measures. Additional risk and net selectivity should be compensated for.

The Jobson and Korkie (1981) transformed Sharpe performance measure emphasises the statistical significance of performance differences using Sharpe ratio. The transformed difference for the Sharpe performance measure is:

$$SH_{ik,Q} = \overline{\sigma}_{k,Q}\,\overline{\mu}_{i,Q} - \overline{\sigma}_{i,Q}\,\overline{\mu}_{k,Q} \quad (5)$$

where $SH_{ik,Q}$ = Transformed Sharpe performance measure difference between portfolios i and k for overall period Q.

$\overline{\mu}_{k,Q}$ = Portfolio i or k average means return premiums for overall period Q.

$\overline{\sigma}_{i,Q}$ = Standard deviation of portfolio i return premiums for overall period Q.

$\overline{\sigma}_{k,Q}$ = Standard deviations of portfolio k return premiums for overall period Q.

The asymptotic distribution for the transformed Sharpe measure is normal with mean $SH_{ik,Q}$ and variance described by:

$$\gamma_Q \frac{1}{N_Q}[2\sigma_{i,Q}{}^2\sigma_{k,Q}{}^2 - 2\sigma_{i,Q}\sigma_{ik,Q} + \frac{1}{2}\mu_{i,Q}{}^2 + \frac{1}{2}\mu_{k,Q}{}^2\sigma_{i,Q}{}^2 - \frac{\mu_{i,Q}\mu_{k,Q}}{2\sigma_{iQ}\sigma_{k,Q}}(\sigma_{ik,Q}{}^2 + \sigma_{i,Q}{}^2\sigma_{k,Q}{}^2)] \quad (6)$$

where

N_Q = sample size for overall period Q.

$\sigma_{ik,Q}$ = Covariance between mean return premiums of portfolios i and k overall period Q.

For any pair of portfolios, the appropriate test is to determine whether the difference in the transformed Sharpe measures, $SH_{ik,Q}$, is statistically equal to zero. The above results lead to the following Transformed Sharpe test statistics.

$$Z_{\sigma\, im,Q} = \frac{SH_{im,Q}}{\sqrt{\gamma_Q}}$$

In this paper, the transformed Sharpe measure is dedicated to comparisons between fund categories and benchmarks, not between individual funds.

5. Empirical Results and Interpretation

The Sharpe measure is computed for each fund (or fund category) using the mean return and the standard deviation of the fund (or fund category), and the mean return of the risk-free asset that corresponds to the same time period. For each fund and fund category, one Sharpe ratio is calculated for the relevant Islamic Index and another for the S&P 500, using the mean return and standard deviation of the index and the mean return of the risk-free asset that correspond to the same time period.

Table 1 lists the results of the fund categories' Sharpe ratios. The Sharpe ratio represents the portfolio excess return per unit of total risk. The higher this ratio, the better the fund's performance is. The Sharpe ratio of the Emerging markets funds is the highest, followed by the Emerging markets-South Africa funds, and the American funds, all of which have positive ratios. Then come respectively the European, the Technology, the Malaysian, the Global and the Asian fund categories, all having negative Sharpe ratios. When comparing each fund category's Sharpe ratio to its relevant Islamic indices, four of the eight categories perform better than the market; these are respectively from the best performing, the Emerging markets, European, American, and the Malaysian fund categories. Compared to the S&P 500, four categories are also performing better than the index, but they are respectively from the best performing, the Emerging markets, Technology, Emerging markets – South Africa, and the American fund categories. Overall, these results are mixed; yet, the Emerging markets category is the best performer compared to its two benchmarks, and the Asian fund category is consistently the worst performer. For the overall sample, the calculated Sharpe ratio is lower than that of both market benchmarks.

Table 1 also provides the number (No.) and the per cent of funds within each category and across categories, which have a greater (or lower) Sharpe ratio than their relative Islamic benchmarks. Over the same period, 29 funds (63 per cent) of the total 46 funds studied outperform their relevant Islamic index. Of the 12 funds (26 per cent) outperforming the S&P 500, eleven funds simultaneously beat the two indices. The highest percentage of funds performing better than their relevant Islamic index is the Emerging markets category with 100 per cent and the lowest is the Asian category with 25 per cent. When compared to the S&P 500, all the funds in the Emerging markets and the Technology categories perform better than the index, whilst all of the funds in the Asian category are poor performers.

Table 2 lists the results of the Treynor ratios per fund category. The Treynor ratio represents the portfolio excess return per unit of systematic risk (beta), and the higher it is, the better the performance. Based on both the relevant Islamic Index and the S&P 500 Index , the Treynor ratio of the Emerging markets-South Africa funds is the highest, followed by the Emerging markets funds and the American funds, all three with positive ratios. When com-

Table 1. – RESULTS OF THE SHARPE RATIOS (BY FUND CATEGORY) MEASURES COMPARISON

Fund Category	No. of Funds	Sharpe Ratio (Fund Category)	Sharpe Ratio (Relevant Islamic Index)	Sharpe Ratio (S&P 500)	Funds vs. Relevant Islamic Index				Funds vs. S&P500			
					$S_{fund} > S_{index}$		$S_{fund} < S_{index}$		$S_{fund} > S_{index}$		$S_{fund} < S_{index}$	
					No.	%	No.	%	No.	%	No.	%
Global	11	–0.1130	–0.0402	0.0156	6	54.55	5	45.45	1	9.09	10	90.91
American	7	0.0214	–0.0014	0.0156	4	57.14	3	42.86	2	28.57	5	71.43
European	4	–0.0278	–0.0585	0.0156	3	75.00	1	25.00	1	25.00	3	75.00
Asian	4	–0.2506	–0.0932	0.0156	1	25.00	3	75.00	0	0.00	4	100.00
Malaysian	14	–0.0860	–0.0932	0.0156	11	78.57	3	21.43	3	21.43	11	78.57
Emerging	2	0.0323	–0.0906	–0.0642	2	100.00	0	0.00	2	100.00	0	0.00
Emerging – South Africa	2	0.0322	0.0395	0.0156	1	50.00	1	50.00	1	50.00	1	50.00
Technology	2	–0.0510	–0.0183	–0.1134	1	50.00	1	50.00	2	100.00	0	0.00
Overall	46	–0.1346	–0.0402	0.0156	29	63.04	17	36.96	12	26.09	34	73.91
Category	8				4	50.00	4	50.00	4	50.00	4	50.00

The Sharpe measure (RVAR) measures the risk premium return earned per unit of total risk of a portfolio. This table lists the names of the 8 fund categories in which the 46 studied Islamic mutual funds are classified, the corresponding number of funds in each category, the Sharpe ratio calculated for each fund category, the Sharpe ratio of each fund category's relevant Islamic index, and the Sharpe ratio of the S&P 500 over the same time period, the number (No.) and the percentage (%) of funds in each category whose Sharpe ratio is either higher or lower than that of the fund's relevant Islamic index, and also the same but using the S&P 500 as market benchmark. The time period may vary depending on the data availability for each fund category, all time periods being within the general study period that extends form January 1, 1997 till August 31, 2002. The same is also calculated for the overall sample, viewed as a portfolio that includes all the 46 studied Islamic mutual funds.

paring each fund category's Treynor ratio to that of the fund category's relevant Islamic indices, four of the eight categories are performing better than the market. These are – from the best performing – the Emerging markets, American, European, and Emerging – South Africa fund categories. Compared to the Treynor ratios of the S&P 500, again four categories are performing better than the index, the Emerging markets, Emerging markets – South Africa, Technology, and the American fund categories. Overall, the Emerging markets category is the best performer compared to its two benchmarks and the Asian and Malaysian categories are the worst performers. Finally, looking at the overall sample, the calculated Treynor ratio is lower than that of both market benchmarks.

Table 2 also shows that over the same period, 13 funds (28 per cent) of the overall 46 funds studied outperform their relevant Islamic index, whilst only 11 funds (24 per cent) outperform the S&P 500, nine of which are common between the two groups. The highest percentage of funds performing better than the Islamic index is for the Emerging markets category with 100 per cent and the lowest is for the Asian and Technology categories with none of their funds performing better than the index. When compared to the S&P 500, all the funds in the Emerging markets and the Technology categories perform better than the index, while all of the funds in the Asian and European categories are under-performing. Overall, Treynor measures results show weaker Islamic Funds performance compared to Sharpe measures results.

Jensen alphas are calculated and analysed, and their relative significances are checked. Table 3 lists the results of the fund categories' Jensen measures. Although about 50 per cent of the Jensen alphas are positive, none is statistically significant, regardless of whether the specific Islamic benchmark or the conventional S&P benchmark is used. Overall, the Emerging markets category is the best performing, compared to its two benchmarks, and the Asian category is the worst performing. Looking at the overall sample, the calculated Jensen alphas are negative based on both the two market benchmarks, though statistically insignificant.

Table 3 also provides the following results. Thirteen funds (28 per cent) of the overall studied 46 funds have positive, but insignificant, alphas. Of the remaining 33 funds (72 per cent) that have negative alphas, only one fund (3 per cent) has a significant alpha at the 5 per cent level. When using the S&P 500, 11 funds (24 per cent) of the overall studied 46 funds have positive alphas, one of which being significant at the 5 per cent level. Of the remaining 35 funds (76 per cent) that have negative alphas, only two funds (6 per cent) have significant alpha at the 5 per cent level. When using the S&P 500, all the funds in the Emerging markets and the technology categories have positive alphas, whilst all of the funds in the Asian and European categories had negative alphas.

Table 2. – RESULTS OF THE TREYNOR RATIOS & MEASURES COMPARISON (BY FUND CATEGORY)

Fund Category	No. of Funds	Based on the Relevant Islamic Index			Based on the S&P 500			Funds vs Relevant Islamic Index				Funds vs S&P500			
		Beta (fund)	Treynor Ratio (fund)	Treynor Ratio (index)	Beta (fund)	Treynor Ratio (fund)	Treynor Ratio (index)	$T_{fund} > T_{index}$		$T_{fund} > T_{index}$		$T_{fund} < T_{index}$		$T_{fund} < T_{index}$	
								No.	%	No.	%	No.	%	No.	%
Global	11	0.8352	–0.0067	–0.0021	0.8010	–0.0070	0.0008	1	9.09	10	90.91	1	9.09	10	90.91
American	7	0.7528	0.0014	–0.0001	0.8997	0.0012	0.0008	4	57.14	3	42.86	2	28.57	5	71.43
European	4	0.8285	–0.0014	–0.0028	0.6140	–0.0020	0.0008	2	50.00	2	50.00	0	0.00	4	100.00
Asian	4	0.8638	–0.0206	–0.0058	0.7518	–0.0237	0.0008	0	0.00	4	100.00	0	0.00	4	100.00
Malaysian	14	0.3803	–0.0234	–0.0058	0.4027	–0.0221	0.0008	3	21.43	11	78.57	3	21.43	11	78.57
Emerging	2	0.6267	0.0031	–0.0051	0.6841	0.0028	–0.0034	2	100.00	0	0.00	2	100.00	0	0.00
Emerging – South Africa	2	0.4485	0.0050	0.0040	0.4294	0.0053	0.0008	1	50.00	1	50.00	1	50.00	1	50.00
Technology	2	0.6215	–0.0087	–0.0025	1.3594	–0.0040	–0.0061	0	0.00	2	100.00	2	100.00	0	0.00
Overall	46	0.7160	–0.0115	–0.0021	0.6547	–0.0125	0.0008	13	28.26	33	71.74	11	23.91	35	76.09
By Category	8							4	50.00	4	50.00	4	50.00	4	50.00

The Treynor measure (RVOI) measures the risk premium return earned per unit of systematic (or non-diversifiable) risk of a portfolio. The table lists the names of the 8 fund categories in which the 46 studied Islamic mutual funds are classified, the corresponding number of funds in each category, the Beta coefficient of each fund category and its Treynor ratio based on the fund category's relevant Islamic Index, the Treynor ratio of the fund category's relevant Islamic Index over the same time period, the number (No.) and the percentage (%) of funds in each category whose Treynor ratio is either higher or lower than that of the fund's relevant Islamic index, and also the same but using the S&P 500 as market benchmark. The same is also listed but based on the S&P 500. The time period may vary depending on the data availability for each fund category, all time periods lying within the general study period that extends form January 1, 1997 till August 31, 2002. The same is also calculated for the overall sample, viewed as a portfolio that includes all the 46 studied Islamic mutual funds.

Table 3. – RESULTS OF THE JENSEN MEASURES

Fund Category	No. of Funds	Based on the Relevant Islamic Index		Based on the S&P 500			Based on Relevant Islamic Index				Based on S&P500			
		Jensen Alpha (fund)	P-Value	Jensen Alpha (fund)	P-Value		Alpha > 0		Alpha < 0		Alpha > 0		Alpha < 0	
							Total	Sig.	Total	Sig.	Total	Sig.	Total	Sig.
						No.	1	0	10	1	1	0	10	1
Global	11	–0.0039	0.1633	–0.0065**	0.0640	%	9.09	0.00	90.91	10.00	9.09	0.00	90.91	10.00
						No.	4	0	3	0	2	0	5	0
American	7	0.0013	0.5859	0.0003	0.8995	%	57.14	0.00	42.86	0.00	28.57	0.00	71.43	0.00
						No.	2	0	2	0	0	0	4	0
European	4	0.0011	0.5864	–0.0018	0.6157	%	50.00	0.00	50.00	0.00	0.00	0.00	100.00	0.00
						No.	0	0	4	0	0	0	4	0
Asian	4	–0.0139*	0.0256	–0.0202*	0.0091	%	0.00	0.00	100.00	0.00	0.00	0.00	100.00	0.00
						No.	3	0	11	1	3	0	11	1
Malaysian	14	–0.0113	0.3709	–0.0141	0.2653	%	21.43	0.00	78.57	9.09	21.43	0.00	78.57	9.09
						No.	2	0	0	0	2	0	0	0
Emerging	2	0.0042	0.5579	0.0033	0.6391	%	100.00	0.00	0.00	0.00	100.00	0.00	0.00	0.00
						No.	1	0	1	0	1	1	1	0
Emerging – South Africa	2	0.0005	0.9150	0.0000	0.9990	%	50.00	0.00	50.00	0.00	50.00	100.00	50.00	0.00
						No.	0	0	2	0	2	0	0	0
Technology	2	–0.0040	0.6803	–0.0007	0.9485	%	0.00	0.00	100.00	0.00	100.00	0.00	0.00	0.00
						No.	13	0	33	2	11	1	35	2
Overall	46	–0.0075	0.2037	–0.0098	0.1235	%	28.26	0.00	71.74	6.06	23.91	9.09	76.09	5.71
By Category	8													
						No.	4	0	4	1	2	0	6	1
						%	50.00	0.00	50.00	25.00	25.00	0.00	75.00	16.67

* Significant alpha value at a 5% level of significance, and ** Significant alpha value at a 10% level of significance

The Jensen alpha measures how much the realized return on a portfolio differs from its required return, based on the systematic (or non-diversifiable) risk of the portfolio. In addition, the significance of the alpha value is assessed by comparing its regression p-value to an adopted level of significance. The table lists the names of the 8 fund categories in which the 46 studied Islamic mutual funds are classified, the corresponding number of funds in each category, the Jensen alpha calculated for each fund category based on the fund category's relevant Islamic Index, the p-value corresponding to the measured alpha, , the (Total) number (No.) and the percentage (%) of funds in each category whose alpha is either positive or negative, and within these funds the number (No.) and the percentage (%) of funds that are significant (Sig.) at 5 per cent level.. The same is also calculated based on the S&P 500 over the same time period. The time period may vary depending on the data availability for each fund category, all time periods being within the general study period that extends form January 1, 1997 till August 31, 2002. The same is also calculated for the overall sample, viewed as a portfolio that includes all the 46 studied Islamic mutual funds. The p-values are compared to a 5 per cent level of significance.

Table 4. – RESULTS OF THE FAMA MEASURES (BY FUND CATEGORY)

Fund Category	No. of Funds	Mean of Fund Returns	Mean of Risk-Free Returns	Overall Returns	Based on the Relevant Islamic Index			Based on the S&P 500		
					Return Premium when Fully Diversified	Reward for Lack of Diversification	Return on Net Selectivity	Return Premium when Fully Diversified	Reward for Lack of Diversification	Return on Net Selectivity
Global	11	–0.0020	0.0036	–0.0056	–0.0018	–0.0002	–0.0036	0.0006	0.0001	–0.0064
American	7	0.0047	0.0036	0.0011	–0.0001	0.0000	0.0011	0.0007	0.0001	0.0003
European	4	0.0025	0.0036	–0.0012	–0.0023	–0.0002	0.0013	0.0005	0.0002	–0.0019
Asian	4	–0.0142	0.0036	–0.0178	–0.0050	–0.0016	–0.0112	0.0006	0.0005	–0.0189
Malaysian	14	–0.0052	0.0036	–0.0089	–0.0022	–0.0074	0.0007	0.0003	0.0013	–0.0105
Emerging	2	0.0055	0.0035	0.0019	–0.0032	–0.0023	0.0074	–0.0023	–0.0016	0.0058
Emerging – South Africa	2	0.0059	0.0036	0.0023	0.0018	0.0010	–0.0005	0.0003	0.0007	0.0012
Technology	2	–0.0020	0.0034	–0.0054	–0.0015	–0.0004	–0.0035	–0.0083	–0.0038	0.0066
Overall	46	–0.0046	0.0036	–0.0082	–0.0015	–0.0009	–0.0058	0.0005	0.0004	–0.0092

The Fama measure provides a breakdown of the overall performance of a portfolio into three sources: compensation for full diversification, reward for lack of diversification, and return on net selectivity. The table lists the names of the 8 fund categories in which the 46 studied Islamic mutual funds are classified, the corresponding number of funds in each category, and for each category, the mean of the average monthly returns of the funds in the corresponding category, the overall returns, the return on full diversification, the return on lack of diversification, and the return on net selectivity. The overall return is the mean of average monthly returns of individual funds in each category. All measures are calculated first using the relevant Islamic indices as benchmark, and then using the S&P 500, over the same time period. The time period may vary depending on the data availability for each fund, and the overall sampling period extends form January 1, 1997 till August 31, 2002.

Next, two sets of Fama measure are calculated, based on the relevant Islamic index and the S&P 500. Table 4 lists the results of the Fama measures per fund category. The overall return is the mean of monthly average returns of individual funds within a fund category. Obviously, whatever benchmark is used, the overall return does not change for

the same group. The results show that the Emerging markets-South Africa category is the best performer given its highest return on overall performance, followed by the Emerging markets fund and the American fund.

Ranked according to net selectivity measure only, and using the relevant Islamic Index as the benchmark, Table 4 shows that the Emerging markets category comes first, followed by the European, American and Malaysian funds, all four with positive returns on net selectivity, implying that they perform above the market line. Based on the S&P 500, first comes the Technology category, followed by the Emerging markets, Emerging markets-South Africa, and the American categories, all four with positive returns on net selectivity.

When testing the return on the fund's risk, which is the return premium when the fund is fully diversified, against the relevant Islamic Index, the Emerging markets-South Africa category has the only positive value, implying that it earns the highest reward for bearing risk. When compared to the S&P 500 Index, the American funds category scores the highest risk-adjusted return, followed by the Global, Asian, European, Emerging markets-South Africa and the Malaysian categories which all have a positive return on the fund's risk.

Concerning the required return on a portfolio for not being totally diversified, the Emerging markets-South Africa category has the strongest performance followed by the American funds category, when compared to the relevant Islamic Index, suggesting that these two categories are the least diversified. When the S&P 500 is used, the Malaysian category becomes the least diversified, followed by the Emerging markets-South Africa, Asian, European, Global, and the American categories, all having positive rewards for their lack of diversification.

Table 5 is similar to Table 4; however, it reports the results of the relative percentages out of the overall performance returns, related to all the funds in each fund category. In other words, the return premium on full diversification (or return on lack of diversification, or return on net selectivity) is calculated by averaging the return premiums on full diversification (or return on lack of diversification, or return on net selectivity) of all the funds in each of the eight fund categories and the overall sample. Here, the overall return is the mean of individual mean returns of funds in a fund category. It can be noted that for the overall sample and based on the relevant Islamic index, that the return on net selectivity, although positive, is not enough to offset returns from full diversification and lack of diversification. Based on the S&P 500, all the returns of the overall sample are negative. When using the S&P 500 Index, the negative overall performance is mainly pertained to the return on

full diversification (56 per cent), whilst the remaining (44 per cent) are driven equally by the return for lack of diversification (22 per cent) and the return on net selectivity (22 per cent).

The Transformed Sharpe measure uses the mean and standard deviation of monthly return premiums for each fund category and the two market benchmarks, the relevant Islamic indices and the S&P 500 Index, and the covariance between the fund category's monthly return premiums and those of each benchmark in the computation. This measure is used to test the significance of the difference in performance between a fund category and its market benchmark.

Based on the whole study period which extends from January 1, 1997 to August 31, 2002, Table 6 – Panel A presents the results of the Transformed Sharpe measure. When compared to the relevant Islamic index, four out of the eight categories outperform their benchmark with positive Transformed Sharpe difference that is significant at the 5 per cent level. These are: the Emerging markets category, followed by the European, American, European and Malaysian fund categories. Of the remaining four categories, only the result of the Asian category is statistically insignificant. When compared to the S&P 500, also four (the Emerging markets category, followed by the Technology category, Emerging markets-South Africa and American categories) out of the eight categories outperform their benchmark with positive Transformed Sharpe difference at the 5 per cent significance level. The other four categories all have negative Transformed Sharpe differences. The overall sample, however, shows a negative significant performance vis-à-vis the two benchmarks.

Next, the results of each sub-period are presented separately. Table 6, Panel B lists the results of the first half of the overall study period, i.e. from January 1, 1997 to October 31, 1999. It can be seen that compared to their relevant Islamic index, only one (the Emerging markets-South Africa category) out of the eight categories outperform the benchmark with positive and statistically significant Transformed Sharpe difference. The remaining seven categories have negative Transformed Sharpe differences, all of which are statistically significant except the Asian and Emerging markets categories. When compared to the S&P 500, the Technology fund category is the only one out of the eight categories that outperforms the benchmark and the difference is significant. As for the overall sample, our results show a negative insignificant performance vis-à-vis the two benchmarks. Obviously the results of the first sub-period differ from those of the entire sampling period presented in Panel A of the same table.

Table 6 – Panel C lists the results of the Transformed Sharpe measures for the second half of the overall study period, i.e. from November 1, 1999 to August 31, 2002. Within this period, it can be noted that compared to their relevant Islamic index, 6 out of the 8 categories outperform their benchmark with positive Transformed Sharpe difference that is significant at the

Table 5. – RESULTS OF THE FAMA RETURNS' PERCENTAGES OUT OF THE FAMA OVERALL PERFORMANCE RETURN

Fund Category	No. of Funds	Overall Returns	Based on Relevant Islamic Index			Based on S&P 500		
			Return Premium Fully Diversified	Reward for Lack of Diversification	Return on Net Selectivity	Return Premium Fully Diversified	Reward for Lack of Diversification	Return on Net Selectivity
Global	11	-0.0141	-0.0115	-0.0018	-0.0007	-0.0078	-0.0015	-0.0048
		100.00%	81.93%	12.95%	5.12%	55.25%	10.82%	33.94%
American	7	-0.0050	-0.0057	-0.0006	0.0013	-0.0051	-0.0005	0.0006
		100.00%	114.33%	12.36%	-26.68%	101.77%	9.70%	-11.48%
European	4	-0.0062	-0.0063	-0.0027	0.0027	-0.0036	-0.0012	-0.0014
		100.00%	101.43%	43.14%	-44.57%	58.50%	19.29%	22.21%
Asian	4	-0.0172	-0.0099	-0.0032	-0.0041	-0.0053	-0.0041	-0.0078
		100.00%	57.53%	18.76%	23.72%	30.59%	23.89%	45.53%
Malaysian	14	-0.0053	-0.0018	-0.0070	0.0035	-0.0002	-0.0007	-0.0045
		100.00%	34.31%	132.18%	-66.49%	2.90%	12.31%	84.79%
Emerging	2	0.0040	-0.0033	-0.0034	0.0107	-0.0024	-0.0027	0.0091
		100.00%	-82.89%	-84.56%	267.46%	-59.62%	-66.47%	226.09%
Emerging-South Africa	2	0.0061	0.0049	0.0012	0.0000	-0.0011	-0.0014	0.0085
		100.00%	80.23%	20.00%	-0.23%	-18.52%	-22.28%	140.80%
Technology	2	-0.0080	-0.0069	-0.0023	0.0012	-0.0166	-0.0091	0.0176
		100.00%	86.05%	28.79%	-14.84%	206.45%	112.58%	-219.03%
Overall	46	-0.0077	-0.0058	-0.0034	0.0015	-0.0043	-0.0017	-0.0017
		100.00%	75.72%	43.90%	-19.62%	56.29%	21.66%	22.05%

The Fama measure provides a breakdown of the overall performance of a portfolio into three sources: compensation for full diversification, reward for lack of diversification, and return on net selectivity. The table lists the names of the 8 fund categories in which the 46 studied Islamic mutual funds are classified, the corresponding number of funds in each category, and for each category, the overall returns (which is the mean of individual fund mean returns within the category), the return on full diversification, the return on lack of diversification, and the return on net selectivity. Here, the overall return is the mean of individual mean returns of all the funds in a category and for the overall sample. The table also reports the relative percentage of each return out of the overall performance. All measures are calculated first using the relevant Islamic indices as benchmark, and then using the S&P 500, over the same time period. The time period may vary depending on the data availability for each fund, and the overall sampling period extends form January 1, 1997 till August 31, 2002.

Table 6. – PANEL A: RESULTS OF THE TRANSFORMED SHARPE MEASURES (OVER THE WHOLE STUDY PERIOD)

Fund Category	No of Funds	**Based on Relevant Islamic Index**			Based on S&P 500		
		$SH_{ik,q}$	Z-score	Test Result	$SH_{ik,q}$	Z-score	Test Result
Global	11	-0.0002	-1.1939	Reject Ho	-0.0003	-1.7169	Accept Ho
American	7	0.0001	0.4324	Reject Ho	0.0000	0.1147	Reject Ho
European	4	0.0001	0.5737	Reject Ho	-0.0001	-0.4732	Reject Ho
Asian	4	-0.0007	-1.7256	Accept Ho	-0.0010	-2.2503	Accept Ho
Malaysian	14	0.0000	0.0482	Reject Ho	-0.0005	-0.6670	Reject Ho
Emerging	2	0.0004	0.9585	Reject Ho	0.0003	0.7659	Reject Ho
Emerging – South Africa	2	-0.0001	-0.1055	Reject Ho	0.0001	0.1155	Reject Ho
Technology	2	-0.0005	-0.3224	Reject Ho	0.0004	0.5303	Reject Ho
Overall	46	-0.0003	-0.8815	Reject Ho	-0.0005	-1.2871	Reject Ho

PANEL B RESULTS OF THE TRANSFORMED SHARPE MEASURES (OVER THE FIRST HALF OF THE STUDY PERIOD)

Fund Category	No of Funds	Based on Relevant Islamic Index			Based on S&P 500		
		$SH_{ik,q}$	Z-score	Test Result	$SH_{ik,q}$	Z-score	Test Result
Global	11	-0.0002	-1.0004	Reject Ho	-0.0004	-1.5253	Reject Ho
American	7	0.0000	-0.0232	Reject Ho	0.0000	-0.0746	Reject Ho
European	4	0.0000	-0.1859	Reject Ho	-0.0002	-0.8901	Reject Ho
Asian	4	-0.0014	-1.8241	Accept Ho	-0.0021	-2.8693	Accept Ho
Malaysian	14	-0.0017	-0.9201	Reject Ho	-0.0030	-2.0814	Accept Ho
Emerging	2	-0.0017	-2.1819	Accept Ho	-0.0017	-2.3714	Accept Ho
Emerging – South Africa	2	0.0001	0.0621	Reject Ho	-0.0012	-1.5213	Reject Ho
Technology	2	-0.0004	-0.3969	Reject Ho	0.0004	0.6601	Reject Ho
Overall	46	-0.0013	-2.1722	Accept Ho	-0.0016	-2.3841	Accept Ho

PANEL C: RESULTS OF THE TRANSFORMED SHARPE MEASURES (OVER THE SECOND HALF OF THE STUDY PERIOD)

Fund Category	No of Funds	Based on Relevant Islamic Index			Based on S&P 500		
		$SH_{ik,q}$	Z-score	Test Result	$SH_{ik,q}$	Z-score	Test Result
Global	11	0.0001	0.2825	Reject Ho	0.0000	0.1129	Reject Ho
American	7	0.0002	1.1404	Reject Ho	0.0002	0.7771	Reject Ho
European	4	0.0003	1.4078	Reject Ho	0.0002	0.6955	Reject Ho
Asian	4	-0.0002	-0.7097	Reject Ho	-0.0002	-0.3799	Reject Ho
Malaysian	14	0.0009	1.2717	Reject Ho	0.0008	1.3513	Reject Ho
Emerging	2	0.0015	3.4772	Accept Ho	0.0013	3.1444	Accept Ho
Emerging – South Africa	2	-0.0001	-0.2454	Reject Ho	0.0010	1.5395	Reject Ho
Technology	2	0.0001	0.0397	Reject Ho	0.0009	1.0601	Reject Ho
Overall	46	0.0004	1.4953	Reject Ho	0.0003	0.9146	Reject Ho

5 per cent level, except for the Emerging markets whose results are not significant. When compared to the S&P 500, 7 out of the 8 categories outperform their benchmark with positive Transformed Sharpe difference, all statistically significant except for the Emerging markets whose results are not significant. The best performer is the Emerging markets category, followed by the Emerging markets-South Africa, Technology, Malaysian, European, American, and the Global categories. The Asian category is the only one with significantly negative Transformed Sharpe differences. As for the overall sample, it displays a positive significant performance vis-à-vis the two benchmarks. Hence, in general, it appears that Islamic mutual funds have shown a strong performance during the recessionary sub-period.

Finally, for each fund and fund category, a One-way ANOVA test of means is conducted, using the monthly returns of the fund or fund category and the monthly returns of the relevant Islamic Index and those of the S&P 500 measured during the overall study period from January 1, 1997 to August 31, 2002. The one-way ANOVA test of means reveals also that there is not any statistically significant difference in the performance of any of the eight Islamic fund categories versus all six Islamic indices as well as the S&P 500 Index, at both the 5 per cent and 10 per cent levels of significance.

6. Conclusion

This study examines the performance of Islamic mutual funds in order to verify whether the application of the Islamic investment guidelines in asset allocation and portfolio selection has had downside effects on investors' wealth in terms of risk-adjusted returns relative to the market benchmark. The results

are somewhat consistent across the different measures and benchmarks used. Over the whole study period, the Emerging markets fund category shows the best performance amongst all of the sampled eight Islamic mutual funds categories, with the Asian fund category being the worst performer. Within the top-performing categories, the American and the Emerging markets-South Africa fund categories follow respectively the Emerging markets category; all three outperforming simultaneously their relevant Islamic index and the S&P 500. In the middle, the European category outperforms its relevant Islamic index (not the S&P 500), while the Technology category outperforms the S&P 500 (not its relevant Islamic index). At the bottom, in general, the Global fund category ranked better than the Malaysian category.

With regard to the overall sample of 46 Islamic mutual funds, the total number of over-performing funds ranges between 29 funds (63 per cent of the sample) and 11 funds (24 per cent), depending on the performance measure and market benchmark used. In terms of the fund category, four of the eight fund categories outperform their benchmarks regardless of what performance measure was used. Moreover, our ANOVA statistical test shows that no statistically significant difference exists in the performance of the funds compared to all indices used. Therefore, the main conclusion of this study is that the behaviour of Islamic mutual funds does not differ from that of other conventional funds, with some *Shari'ah* compliant mutual funds over-performing their benchmarks and others under-performing.

Another interesting finding is observed when studying the performance of the funds over two successive periods within the overall study period. The first witnessed a booming equity market, while the second was a declining market. The results of the Transformed Sharpe measure showed that the performance of the Islamic mutual funds compared to both benchmarks used during the second period dominated by recession, is better than during the first booming sub-period. This implies that the performance of these funds is improving with time, as fund managers are gaining more experience and a sense of the market. Another implication from this result is that Islamic mutual funds might be a good hedging investment for any equity investor, if used to hedge against market downturns and recessions.

In general, the results suggest that there is no statistically significant risk-adjusted abnormal reward or penalty associated with investing in *Shari'ah* compliant mutual funds, and therefore with following one's belief in financial investment. Therefore, conventional investors can consider Islamic mutual funds in their portfolio collection, especially during slow market periods. However, the onus remains on the investor to always screen various candidate mutual funds according to their performance regardless of whether the fund is a conventional, Islamic, or ethical one etc.

Several limitations are encountered during this study given the age of the funds studied. The small size sample of 46 funds was unavoidable due to

limited data availability and the two-years of data inclusion constraint. Also, the 68 months sampling period used in this study is the most appropriate as it allowed us to observe returns over two distinct market cycles. However, longer historical performance data in the future may lead to more robust and conclusive results. Another limitation is that due to the young age of Islamic funds, the newly added categories, namely the balanced or secured funds and the Islamic bonds funds, are not represented in the study as none had more than two-years of data. Adding these funds in future studies will certainly paint a different picture of the industry, especially due to their relatively less risky nature compared to funds in the other sampled categories.

The above limitations could be avoided in the future when more historical performance data is available on the Islamic mutual funds. A matched-pair analysis of performance could be carried out between Islamic mutual funds and conventional ones (ethical and non-ethical). The matching may be done on the basis of size, age, country, and universe of investment, amongst others.

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OBIYATHULLA ISMATH BACHA

Value Preservation through Risk Management A Shariah Compliant Proposal for Equity Risk Management

Abstract

This paper makes the case for the preservation of Muslim Wealth through risk management. It provides an exposition of risk management techniques used in conventional finance and outlines the limitations faced by Muslim fund managers and businesses. This limitation arises from the proscription of key risk-management tools, in particular financial derivatives. Though the reasons for the prohibition are diverse, the overriding concern appears to be that they encourage speculative behaviour. As such, the emphasis of Islamic risk management has been on On Balance Sheet methods. The problem with On Balance Sheet methods is that they require the restructuring of business transactions which can render businesses less competitive and subject to residual risk. The paper proposes a portfolio insurance scheme that uses the logic and mechanics of conventional Index Put Options but in a Shariah compliant manner. The proposal is intended to strike a balance between the need to avoid speculation and the genuine need for hedging equity risks.

1. Introduction

If there is one key feature that has an equal presence in both Islamic and Conventional Financial Systems, it must be the presence of Risk. While much has been done in conventional financial markets to both tame and minimise risk, the same cannot be said of Islamic capital markets. This lack of attention to the management of risk has meant that players in Islamic Capital Markets have little by which to ensure the preservation of their wealth. Islamic businesses and mutual funds are therefore often left to take the brunt of the exposures that arise in their operating environments. One can cite several reasons for this lack of attention to the management of risk and the consequent preservation of value. First and foremost is perhaps the lack of appreciation, in particular among the jurists, of the need to manage risk. A second reason could be the suspicion held by most *Shariah* scholars to conventional risk management tools, most of which are financial derivatives. Yet another reason could be attributed to the argument that according to the *Shariah*, in order to avoid *riba* and justify a return, one must either expend effort or have taken on risk.

While this inadequacy may not have been a serious constraint when a capital market is still small, the ability to manage the risks that arise from business transactions becomes critical as the market develops. The ability to innovate

new techniques and instruments to manage the risks endemic of capital markets determines whether a market goes on to a subsequent phase of development or remains under-developed. Players must have the ability to keep the level of risk they deem acceptable and lay off or reduce any risk beyond this preferred level. Since risk preference differs among investors, well functioning capital markets must have the means by which to shift these risks. An inability to dissipate risk through redistribution leads to risk concentration, which in turn renders capital markets and their financial systems vulnerable. Islamic Capital Markets, now in their development stage, must grapple with the issue of risk management if they are to develop further. This will be particularly true for economies where Islamic Capital Markets are envisaged to take centre stage.

The objectives of this paper are threefold. The first is to make a case for risk management and to show that continued negligence can be inimical to the future development of Islamic Capital Markets. The second objective is to provide an exposition of the key risk management techniques used in conventional finance and show how proscribing these techniques/instruments can be hugely disadvantageous to Muslim investors. The third objective of this paper is to propose a risk management alternative that uses the logic of proscribed derivatives, to manage equity risks.

This paper is divided into five sections. Section 2 below, introduces key risk categories, defines risk management and outlines common conventional risk management techniques. Section 3, discusses the stand of Shariah scholars on the use of financial derivatives, which are typically the building blocks of conventional risk management. Section 4 lays out the proposed alternative arrangement for managing equity risks. The final section, Section 5 concludes.

2. Risks and Value Preservation through Risk Management

Risk from a conventional finance viewpoint, refers to the uncertainties associated with returns from an investment. These uncertainties would translate into volatility or the fluctuation of the expected returns from an investment. Since, fluctuation of returns is dispersion around a mean, the commonly accepted measure of risk is standard deviation (σ). Thus, unless an asset comes with "guaranteed" fixed future returns, it has some amount of uncertainty and therefore risk. In fact, even a "guaranteed" instrument such as a government bond has risks if either the issuer's credit worthiness is questionable or other externalities like inflation is present. In a sense, there is really no such a thing as a truly risk-free asset. Risk is ever present in capital markets. Risk management, refers to the process/techniques employed in reducing the risks faced in an investment. It generally involves three broad steps:

(i) Identifying the source and type of risk.

(ii) Measuring the degree or extent of the risk.

(iii) Determining the appropriate response or methods to be used.

While numerous risk management techniques are possible, these can generally be categorised into two broad methodologies, i.e. the use of on balance sheet or off balance sheet methods. The first refers to the process of restructuring business transactions in a way that will minimize asset-liability mismatches in the balance sheet. The latter refers to the use of external, usually exchange traded derivatives to offset risks that arise from a business transaction. Since the use of derivatives is external to the transaction, these positions have no impact on the operational assets or liabilities of the firm and so do not show up in the balance sheet. However, since exchange traded derivatives are standardized, highly liquid, have low transaction costs and do not involve changing existing business methods, managing risk by means of off balance sheet methods are by far more popular in conventional systems.

What makes risk management challenging is the fact that risks and returns are generally positively correlated. In reducing risk one invariably has to sacrifice potential returns – thus the risk-return trade-off. The challenge is to protect the expected returns while simultaneously reducing or laying off the risks.

2.1. Types of Risks & Hedging

Numerous types of risks are prevalent in capital markets. The more common of these are (i) *market/price risk*, which refers to changes in returns caused by changes in market prices of the asset, (ii) *inflation risk*; which refers to the erosion in purchasing power (iii) *interest rate risk* can be either in the form of a change in asset prices arising from interest rate changes or as a change in the cost of funds/capital, (iv) *default/credit risk* which arises when a debtor is unable to meet its obligations, (v) *liquidity risk*, the risk that arises from infrequent or thin trading of an asset, and finally, (vi) *currency/foreign exchange risk*, refers to the potential losses that can result when the exchange rate of a currency to be received falls in value against home currency or a foreign currency in which a payment is to be made appreciates against home currency.

In addition to these types of exposures or risks that may arise directly from having undertaken a transaction, one could also face indirect risks. For example, a bank with solely domestic activities may not have direct foreign exchange exposure but could have extensive indirect foreign exposure through its clients.

In a narrow sense, risk management can be thought of as hedging. Hedging is quite simply the process of protecting one's investment value by establishing a hedge transaction, which has a risk profile exactly the opposite of the original

exposure. The basic idea is to offset the volatility in the underlying asset with that of the hedge position. Since price movements in the two positions exactly offset one another, a fully hedged position would have zero fluctuation and therefore zero (or negligible) standard deviation.

Having outlined risk management, types of risks and hedging, the remainder of this section will examine indepth, two key risks in capital markets, (i) equity (price) risk and currency/foreign exchange risk. We will examine what these risks are, how they impact the value of one's assets and what techniques are available to manage these risks in conventional systems. This will be followed by a discussion of which of these techniques are shariah compliant and would therefore be useable in preserving Muslim wealth.

2.2. Equity Risk and its Management

Going by our earlier definition of risk as volatility/fluctuation, fluctuations in equity prices cause volatility of equity returns and thereby hurt wealth creation. The most basic form of equity risk management is *diversification*. Diversification refers to the expansion of a portfolio across different assets or stocks in order to reduce risk; i.e., portfolio standard deviation. The reason portfolio standard deviation reduces with the mere inclusion of additional shares has to with correlation. Since no two assets are likely to have a perfectly positive correlation, the inclusion of even a randomly selected stock reduces portfolio standard deviation. Diversification however has its limits. Even a fully diversified portfolio does not reduce risk to zero, but has residual risk known as; *systematic risk*.

No amount of further diversification across stocks in a given market (country) can reduce the systematic risk. Further reduction in systematic risk is only possible with international diversification. This however, leads to the creation of yet other risks. As we will see shortly, the advent of financial derivatives has dramatically changed this limitation.

Asset Allocation

A second basic form of equity risk management is asset allocation. Asset allocation is usually intended to change portfolio composition according to market outlook. Though intended largely to take advantage of expected market movements, the fact that it changes portfolio risk profiles, implies that asset allocation too can be a form of equity risk management. Like diversification however, asset allocation too has its limits. In some ways, asset allocation is betting on market movements. And, like all expectation plays, it can be hazardous. A fund manager has to get both the timing and stock selection correct.

2.3. Equity Derivatives

Whereas the two basic strategies, diversification and asset allocation were limited in scope, the advent of derivative instruments brought a whole new range of possibilities to risk management. Not only did it become possible to overcome the limitations of the basic strategies, but entire new strategies to alter risk profiles became possible. Using equity derivatives, one could lock-in expected values and thereby avoid volatility, establish positions to take advantage of volatility or combine the two to both lock-in base values while simultaneously taking advantage of volatility. The most commonly used equity derivatives in risk management have been Stock Index Futures contracts and index/equity options.

2.3.1. Stock Index Futures Contracts (SIF)

In using SIF contracts two new possibilities opened up for risk managers. First, was the ability to manage overall equity exposure and second, the ability to further reduce systematic risk.

Systematic risk, which is the residual risk that remains even with full diversification, becomes manageable with SIF contracts. Suppose a portfolio manager, given a bearish short-term outlook intends to reduce by half the systematic risk of his portfolio, the hedge would be to combine his portfolio with *a short position in SIF contracts equivalent to half his portfolio value*. If a 3-month SIF contract is used for the purpose, the portfolio's systematic risk is halved for the 3-month period of the hedge. Following expiry of the SIF contracts, the systematic risk returns to its prior level. Thus, SIF contracts not only enable one to change the risk profile of an equity portfolio, but to do so as and when desired.

In the absence of SIF contracts, changing portfolio composition to reduce systematic risk is a very difficult process. It is time consuming, iterative and expensive. With SIF contracts, hedging such risk becomes easy and inexpensive.

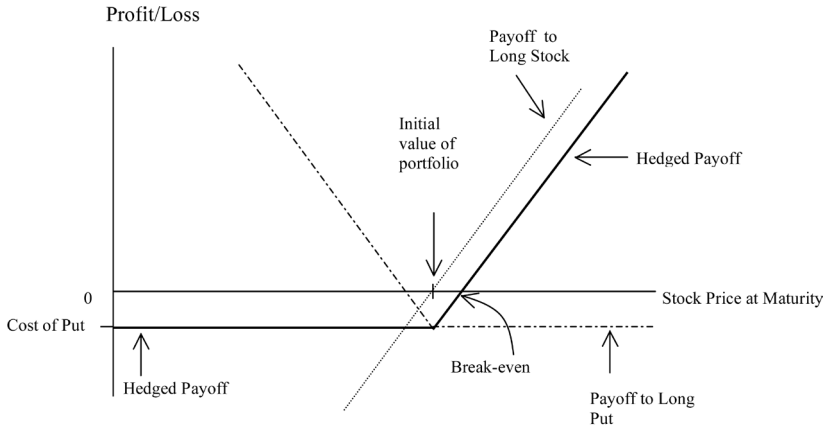
When one wants to manage the overall equity exposure, SIF contracts can be used to ***"lock-in"*** the value of an existing portfolio. This is classic wealth preservation. One manages equity risk by hedging the current portfolio using SIF contracts to lock-in a value *regardless* of underlying market movement. Such a hedge is established by shorting an amount of SIF Contracts adjusted for the portfolio's systematic risk or *beta*. This combined portfolio of short futures and the original stock position preserves overall value because any diminution in the value of stocks should be offset by profits on the futures position. A fully hedged position such as this reduces equity price risk to zero but does not have zero returns. Since the overall combined position is risk free, it mimics a riskless asset and therefore has earnings equal to the risk-free rate of return. In a sense, the combined long stock, short SIF position syn-

thesizes a long Treasury bill position. Thus, not only do we not lose anything when the market falls, we *add* an amount approximating the risk free rate to the original value of our wealth. Furthermore, since one can easily replicate a long treasury bill position using SIF contracts, asset-allocation strategies too become easier and a lot cheaper with SIF contracts.

2.3.2. Equity Options/Index Options

Unlike SIF contracts that 'lock in' a portfolio value, the advent of equity / index options has meant that risk-management need not just be about risk reduction. Using options, it becomes possible to simultaneously reduce risk while also keeping the upside profit potential intact. This inherent flexibility has meant that options have become a key tool in equity risk management. Though numerous option-based strategies are possible, the most popular where equity risk management is concerned is known as ***Portfolio Insurance***. Portfolio Insurance involves the use of put options in order to hedge equity risk. Portfolio managers would use index put options to *limit downside risk while keeping intact upside potential.* A portfolio insurance strategy therefore provides both downside protection and upside potential. This is the value added of using options over futures. Figure 1 below shows the payoff profile to a typical portfolio insurance strategy.

Figure 1. – PAYOFF PROFILE TO PORTFOLIO INSURANCE



The hedged payoff represented by the bold line shows how the strategy limits downside risk while keeping upside potential intact. The maximum loss to the strategy would be the total premium paid for the purchase of at-the-money puts. The upside profit potential equals portfolio value beyond its initial value less the premiums paid. Note that the hedged payoff replicates that of a long call position. In both the portfolio insurance and the earlier strategy using SIF contracts, the risk manager uses derivatives to *financially engineer* a different desired risk profile.

2.4. Alternatives for Islamic Portfolio Managers

The above illustrations showed how the impact of downside risk to equity portfolios can be muted by use of financial derivatives. It should be noted that aside from the above portfolio insurance strategies numerous other trading strategies to fit different market scenarios are possible with derivatives. However, as things now stand, with the exception of the most basic risk management tools; diversification and asset allocation, none of the other techniques are currently available to managers of Islamic portfolios. Recall that diversification only helps up to a point. With most global equity markets having fallen on average close to 40 per cent over the last 3 years, even fully diversified stock portfolios would have fallen as much. The limitation of asset allocation strategy is that it requires managers to make a call on future market movements. Empirical studies have shown that active asset allocation strategies seldom outperform over the long term. So, what can an Islamic fund manager do to preserve the value of his portfolio and the wealth of his Muslim investors? The answer as it stands now is very little!

2.5. Currency / Exchange Rate Risk

If there are serious handicaps to Islamic equity managers, a similar situation prevails for the Muslim firm facing currency or exchange rate risk. Given the systematic nature of currency risk, an Islamic firm engaged in international trade is just as exposed as non-Islamic ones. Value destruction happens with currency exposure, when a receivable foreign currency depreciates or a foreign currency, in which a payable has to be made, appreciates. It is in the area of currency risk management that most of the innovation in risk management has occurred. As in the case of all exposures, currency risk can be managed by either on or off Balance Sheet methods. The easier and by far more popular method is to use off Balance Sheet techniques using currency derivatives. The table below summarizes the appropriate hedge position for the four most popular currency derivatives.

HEDGE STRATEGIES WITH COMMON CURRENCY DERIVATIVES

Currency Derivative	***To Protect Against Currency***	
	Appreciation	**Depreciation**
– Forwards	Long	Short
– Swaps	Long	Short
– Futures	Long	Short
– Options	Long Call	Long Put

While the above methods simply involve buying or establishing the appropriate position in mostly exchange traded derivatives without the need to change the underlying foreign currency transaction, the on balance sheet methods described below require either a restructuring of the original underlying

transaction or using customised techniques. Among the more common customised techniques to managing currency risk are as follows:

(i) *Exposure Netting*; Involves the creation of an offsetting exposure in the foreign currency. For example, if we are to receive a payment in Japanese ¥en in the future, we hedge by creating a ¥en payable for the same amount and maturity. This essentially means buying something in Japan for the amount of our receivable on an equal credit term.

(ii) *Pricing Strategy*; Here we hedge the potential exchange rate loss by marking up the price we quote for a foreign currency denominated transaction.

(iii) *Money Market Hedge*; Involves the use of simultaneous borrowing and lending in two different currencies in order to 'lock-in' the home currency value of the underlying transaction. For example, to hedge a foreign currency receivable, we borrow in the foreign currency, covert to home currency at the spot rate and immediately deposit it in a domestic bank for a tenor equal to the receivable period. The amount borrowed in foreign currency should equal the present value of the receivable.

(iv) *Currency Risk Sharing Agreement* (*CRSA*); is an agreement under which the two parties agree to carry out a transaction at an exchange rate that splits the profit/loss for large exchange rate movements. The sharing takes place for spot rates that fall outside a predetermined "neutral zone".

In contrast to the hedging techniques that use derivative instruments, the customized on Balance Sheet techniques, are usually more difficult to establish and have serious inadequacies. Exposure netting is easier said than done. Often there is nothing suitable that a company can buy in the foreign country in order to create the liability. Worse, other risks are often created in the process. The use of Pricing strategy has the serious downside that it would render the firm uncompetitive. Particularly, against non-Muslim businesses that can easily use derivatives to hedge at much lower/neglible costs. Yet, given the current state of affairs, the only exchange rate risk management techniques available for Islamic fund managers/businesses, would be customized hedges such as CRSA and Exposure Netting. The problem here is that the underlying transaction itself has to be restructured. Unless the foreign customer is encumbered in some way, they could easily take their business elsewhere.

3. Risk Management & Islamic Finance – the Current State of Affairs

If there is one conclusion that we can draw from our discussion, it is that Muslim businesses face the same risk exposures that conventional ones do. Yet, the alternatives available to them to manage these risks are severely limited. The limitation arises from the fact that current thinking among Islamic

jurists seems to be that while customized methods are acceptable, the use of exchange traded (standardised) instruments such as derivatives should be disallowed. Such a stand has two implications on the preservation of value and wealth creation of Muslim businesses. First, it keeps them vulnerable to value loss and second, renders them less competitive. In a zero sum world, if we imagine two firms trading with each other, if one side is able to fully hedge while the other is unable to, losses incurred by one will constitute the gains to the other. Wealth is being transferred from the unhedged to the hedged. Over time, this can have disastrous consequences on Muslim wealth creation.

While an evaluation of fatwas on derivatives is beyond the scope of this paper and is not the intention here, an overview of the current stand would be useful in the context of our discussion. As any student of Islamic finance would agree, the jury is still out as far as a definitive opinion on derivatives is concerned. The validity and permissibility of these instruments appears to vary by scholar/jurists. Even where Islamic scholars have found them objectionable, their reasons for objection differ. There does not appear to be a consensus. Much of the work by Islamic scholars has been of a highly juridical nature. They examine derivatives within narrow confines of contractual arrangements and thereby miss the broader picture of why instruments like futures and options are needed in modern business environments. The table below provides a sample of some of the opinions of Islamic scholars.

Table 1. – OPINION ON EXCHANGE TRADED FUTURES

Source	Summary of Opinion
Fatwa of Omam Al-Haramaini Al-Jauwaini	Futures Trading is Halal if the practice is based on *Darurah* and the Needs or *Hajaat* of the Ummah.
Syariah Advisory Council (SAC) of Securities Commission, Malaysia	– Futures trading of commodities is approved as long as underlying asset is halal. – Crude Palm Oil Futures Contracts are approved for trading. – For Stock Index Futures (SIF) contract, the concept is approved. Thus, it implies that a Stock Index Futures contract of a halal index would be acceptable.
Ustaz Ahmad Allam; (Islamic Fiqh Academy – Jeddah, 1992)	– Stock Index Futures (SIF) trading is Haram, since some of the underlying stocks are not halal. – Until and unless the underlying asset or basket of securities in the SIF is all Halal, SIF trading is not approved.
Mufti Taqi Usmani (Fiqh Academy – Jeddah)	– Futures transactions not permissible, for two reasons: (i) According to Syariah, sale or purchase cannot be affected for a future date. (ii) In most futures transactions delivery or possession is not intended.

Table 2. – OPINION ON EXCHANGE TRADED OPTIONS

Source	Summary of Opinion
Ahmad Muhayyuddin Hassan	– Objects to option trading for 2 reasons (i) Maturity beyond three days as in-khiyarat is not acceptable. (ii) The buyer gets more benefits than the seller, this constitutes injustice.
Abu Sulayman (Fiqh Academy – Jeddah, 1992)	– Acceptable when viewed in the light of bai-al-urbun but considers options to have been detached and independent of the underlying asset – therefore: unacceptable.
Mufti Taqi Usmani (Fiqh Academy – Jeddah)	– Promises as part of a contract are acceptable in Shariah, however the trading and charging of a premium for the promise is not acceptable. Yet others have argued against options by invoking "maisir" or unearned gains. That is, the profits from options may be unearned.
Hashim Kamali (1998, International Islamic University, Malaysia)	– Finds options acceptable i. Invokes the Hanbali tradition, cited Hadiths of Barira (RA) and Habban Ibn Munqidh (RA). ii. Also draws parallels with the al-urbun in arguing that premiums are acceptable. iii. Cites that contemporary scholars such as Yusuf al-Qaradawi and Mustafa al-Zarqa have authenticated al-urbun.
Shariah Advisory Council (SAC) Securities Commission, Malaysian	– No formal opinion on options. The fact that there are no equity options, only index options available currently has meant that there is no urgency. Index options are disallowed based on the argument that some of the stocks in the KLSE CI are non-halal. – However, the SAC has approved as halal, the trading of Warrants/TSRs as long as the underlying stock is designated as a halal stock. *(Note that warrants as traded in Malaysia are essentially long-dated Call options. They have exactly the same payoff profile as Calls).*

The fractions nature of the debate and opinions is obvious. It appears that any number of objections could be made for a given derivative instrument. The object of juridical analysis appears to be a micro examination of each and every feature of a derivative instrument to see if it passes, an often subjective religious filter. Neither the overall intended use of the instrument, nor the societal benefits that could accrue, seem to have been given due consideration. Aside from individual interpretation, the differing opinions among mazhabs / imams complicate the situation further. Thus, an option contract may be found objectionable for completely opposite reasons. For example, when seen from the viewpoint of the subject of sale (mahal al aqd), the subject of sale in options are rights / obligations which some, such as Abu Sulayman (1992) find objectionable. The thinking is that rights / obligations are different (detached) from the underlying asset. When seen solely as conferring rights / obligations, options are indeed different from their underlying asset. Based on this line of reasoning, while the sale / purchase of assets are entirely acceptable, prohibition is based on the fact that transactions in abstract matters such as rights and obligations are not recognised in the sharia.

On the other hand, if options as derivatives are considered attached to the underlying asset, then objections have been made on the problem of paired contractual obligations ('aqdayn fi aqd). The existence of paired contractual obligations invalidates both the option contract and the sale contract of the underlying asset. Thus, to summarise, an option may be found objectionable if it is deemed to be independent of its underlying asset and again objectionable if it is dependent and therefore paired. The irony that an instrument could be prohibited based on two diametrically opposite viewpoints appears to have been lost.

The above example illustrates the difficulty in arriving at any form of consensus. While some mazhabs such as the Hanbalis have been broader in their acceptance, the Shafi' and Hanafis have been less so. The Hanbalis for example are somewhat liberal when it comes to the option of stipulation (Khiyar-al-Shart). They uphold that stipulations that remove a hardship, fulfil a legitimate need, provide a benefit, or facilitate the smooth flow of commercial transactions are generally acceptable as a matter of principle.

The above prohibitions not withstanding, the fact that risk management realities may make it inevitable to use derivative instruments is shown by the fact that surveys carried out by the Islamic Development Bank (IDB) find that some Islamic Financial Institutions (IFIs) indeed use off Balance Sheet hedging tools such as forwards, swaps etc. in managing their currency risk. (Khan and Ahmed, 2001).

Regardless of what their main reasons for objecting to these instruments may be, a common concern appears to be that enabling the use of derivatives could lead to potential speculative behaviour. While this concern is indeed a legitimate one, particularly in view of recent scandals involving derivatives, a clear balance has to be reached between the need to avoid speculative abuse and the need to use these instruments for genuine hedging. There is obviously a legitimate need to use these instruments for preserving value / wealth.

4. A Proposed Alternative to Value Preservation by Managing Equity Risk

In this section, a proposed alternative to value preservation through the management of equity risk is outlined. The focus is solely on the preservation of wealth invested in equity instruments. The proposal is built on the need to strike a balance between avoiding speculative behaviour and enabling genuine hedging needs. The leverage inherent of derivative instruments makes them highly amenable to speculative play, with potentially disastrous consequences to efforts of wealth preservation. However, by not being able to hedge with these instruments and exposing one's wealth to otherwise easily manageable risks, is being imprudent and equally irresponsible, as is speculation.

The objective of the proposal is not to 'engineer' Islamic forms of conventional derivatives but to create an institutional arrangement which will alter the risk profile of an existing equity portfolio to that of a less risky one. To see how the proposal will work, we use the example of an Islamic mutual fund or unit trust faced with equity risks. Remember that currently, aside from diversification and asset allocation, Islamic Mutual funds have no means of hedging sudden downward swings in stock prices.

The proposed arrangement uses the logic of institutions already in place in conventional systems, to protect consumers who may not be able to hedge their exposures. One example, in the context of banking, is the FDIC (Federal Deposit Insurance Corporation) of the US. Based on this logic, the proposal requires the establishment of a government or quasi government agency with initial capital from the government. The FDIC is not government funded, but by an industry levy on private institutions. Its obligations, however, are guaranteed by the government. Just as the FDIC's role is to provide deposit insurance to depositors who otherwise have no means of hedging their risk, the proposed agency's role will be to protect Muslim wealth invested in equity by selling "portfolio insurance" to Islamic Mutual funds. In essence, the agency sells certificates that work like conventional Index Put options with perhaps a one-year maturity. In exchange for paying premiums, the Islamic Mutual fund receives put certificates of a given face value, exercisable anytime within the one-year maturity period. Should the mutual fund experience a diminution in its portfolio and decide to exercise its put certificates, it will exercise by selling the insured portion of its portfolio at the market price that prevailed at the time of insurance. As with conventional derivatives, such exercises can be carried out only once until maturity and would be exercisable in full.

At this point, several questions arise. Given the several banking failures in the US, even with the presence of the FDIC, insurance is obviously no panacea. The essential questions that need to be addressed would be:

(i) How will the premiums be determined?

(ii) How will it handle the potentially huge moral hazard problems and abuses?

(iii) How will the agency offering the insurance, hedge its own exposure?

(iv) Who would be the ultimate beneficiaries of this proposal and why would Islamic Mutual funds want to participate?

The discussion that follows will be organised in the order of the above questions. For ease of identification, let us name this proposed agency IEGC (Islamic Equity Guarantee Corporation). As mentioned previously, IEGC sells portfolio insurance to Islamic Mutual funds in exchange for premiums. In essence, IEGC provides a guarantee against stock price declines. Experience, however, shows that guarantees, especially blanket ones are subject to serious

abuse. Thus, for the proposal to be workable, safeguards and control systems must be built in.

In the subsections that follow, we address the above questions and outline some of the safeguards and operational controls that will be needed for the proposed agency to function well.

4.1. Determination of Premiums

Premiums charged by the IEGC will be dependent on two factors; first on the overall level of risk of a mutual fund's portfolio, and second on the Face Value of the amount to be insured. Both of these are logical determinants of premiums in conventional insurance and are intended to protect the insurer. Since the assets to be insured are publicly listed and exchange traded stocks, measuring their level of risk is relatively straightforward. The overall Beta (systematic risk) of the mutual fund's portfolio could be the level of risk measure. Thus, higher risk portfolios would be subject to higher premiums, whereas lower risk ones, lower premium. The second determinant, the insured amount would obviously depend on the size of the mutual fund. However, in keeping with experience of insured regimes, it is proposed that the total amount insured be capped at a maximum of perhaps 30 per cent of the total value of the fund to be insured. For example, suppose a mutual fund currently has a stock portfolio with a total current value of RM100 million. The value insured for such a fund should be RM30 million. This means that the insured mutual fund when exercising its put certificates will receive RM30 million from IEGC in exchange for 30 per cent of its portfolio. Thus, the mutual fund gets to sell the stocks within the insured 30 per cent of its total portfolio at the original value that prevailed at the time of insurance. IEGC now becomes the owner of these stocks. Any losses beyond the 30 per cent will be borne by the fund's investors/unit holders. Thus, the proposed arrangement is really a partial, not a full hedge.

4.2. Safeguards against Moral Hazard

The key to the success of any guarantee scheme would be the avoidance of problems related to moral hazard. To be workable, the proposed arrangement must not give fund managers the incentive to increase portfolio risk subsequent to being insured, nor induce dysfunctional behaviour along moral hazard lines. There are four reasons why moral hazard will be controlled in this proposed arrangement.

(i) Premiums are dependent on risk; higher risk portfolios will be penalised with higher premiums. Since the monitoring of a fund's portfolio risk post-insurance will be continual, subsequent increases in the overall portfolio will incur additional premiums. The continuous monitoring of in-

sured mutual funds is not difficult. In fact for all public mutual funds, the trustees appointed as part of the approval process already monitor their funds. Mutual funds are required to report all transactions to the trustee. Thus, the IEGC would merely have to latch on to this mechanism in order to monitor the mutual funds.

(ii) Since the assets being hedged are stocks that are publicly listed and traded, tracking their price movements or monitoring other events relevant to particular stock portfolios is not difficult. In fact, compared to the effort required to monitor the quality of a bank's loans portfolio, as does the FDIC, this will be a lot easier and cheaper and can be done on a high frequency basis.

(iii) The third reason why there is in-built control against moral hazard is the fact that even with the portfolio insurance, the hedge is a partial, not a total one. Since mutual funds will be covered only up to a maximum 30 per cent of the total value of the funds, it will be in the interest of mutual fund managers to act prudently.

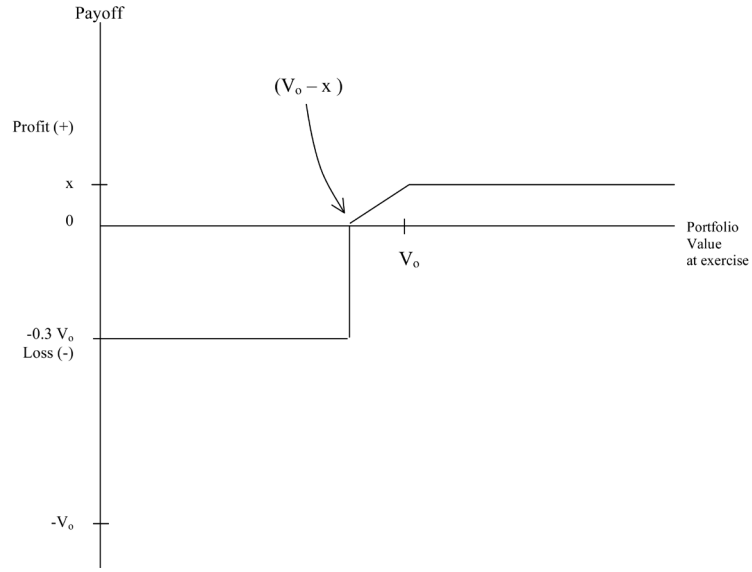
(iv) Finally, moral hazard is also controlled by the fact that the put option bought from the IEGC is exercisable only once and in full within the one-year maturity. This is a feature common to even exchange traded derivatives. Since the option is exercisable only once and in full, fund managers will have to think carefully before exercising and taking profit. Once exercised, the insurance lapses, and a new one has to be bought, at a new premium. The mutual fund will also have to give up on the portion of portfolio insured. Thus, it will not be in the fund manager's interest to exercise when there are small dips in prices and / or when he thinks the downturn is temporary.

4.3. How would IEGC manage its exposure?

In selling portfolio insurance, it is clear that the IEGC will be taking on the portfolio risks passed on it. A portion of the equity risk of Islamic Mutual funds is being transferred to the insurer. The cumulative total will be substantial. This risk must be managed. Unless carefully managed, the entity's initial capital could be quickly wiped out. In charging premiums according to portfolio risk and by limiting exposure to a maximum 30 per cent of a fund's total value, the agency has taken the first steps in managing exposure.

Figure 2 below, shows the risk profile to the IEGC. Note that the agency's profit (from premium) is limited to the area between the horizontal axis and X. Its losses, however, have a potential maximum of -0.3 V_o, where V_o is the portfolio value at the time the insurance is initiated. The point 0.3 V_o, reflects the 30 per cent cap on total value of portfolio insured. At any point to the right of V_o, the agency keeps its premium. Losses are incurred when portfolio value falls below, (V_o – x).

Figure 2. – PAYOFF AND RISK PROFILE TO IEGC



In capping the value insured for a mutual fund, the IEGC is limiting its downside. As such, the risk profile of the agency is one of limited upside (profit potential) and limited downside (loss potential). Next, it has to do what all insurance companies do – invest its capital and proceeds from premiums collected in returnable earnings. Relative to a typical insurance company however, the IEGC has greater exposure to systematic risk. This is because, unlike fire, accident or other such insurance where the events are independent and uncorrelated, stock price movements are. A sliding stock market where most stocks fall together is entirely possible. Such systemic risk is also the case with banking and therefore FDIC type insurance. This is why, in insuring situations such as this, government participation is needed. Still, the IEGC has one advantage over conventional insurance, it takes possession of the insured asset once the insured party exercises. This is unlike conventional insurance, which simply pays for the losses but does not take over the insured asset. On exercise, IEGC takes possession of the insured portion of the stock portfolio.

In the absence of Islamically acceptable derivatives with which to hedge itself, the logical means by which IEGC manages its risks would be to invest in assets uncorrelated to equity movements. The first such asset would be Islamic bonds, Green bills, Islamic Certificates of deposits etc. Additionally, investment in real estate assets, utilities, infrastructure projects and other halal businesses should be acceptable. Income from these investments, its holdings of stocks taken over from mutual funds, together with premiums received, should be used to build on the initial capital. By investing in a wide range of projects, IEGC will be diversifying and so managing its risk. In holding on to the stocks it has received on exercise by mutual funds, IEGC has the potential to gain from subsequent recovery in the stock prices. As an institution not

subject to short term performance measures the way mutual funds are, IEGC can afford to hold on to these stocks for longer periods. Finally, to further diversify and reduce risk, the practice of conventional insurance companies to undertake cross border reinsurance should also be possible here. In this situation, agencies similar to IEGC in other Muslim countries could invest in each other, thereby dissipating the risk of any one entity through cross border diversification.

4.4. Related Issues

Two related issues remain in this discussion. The first is the question of who is really being helped by this portfolio insurance proposal and second, why should Islamic mutual funds be willing to participate in this scheme. In addressing the first, it should be obvious that the ultimate beneficiary would be individual Muslim investors in mutual funds. Mutual fund investment is a form of saving and constitutes a key portion of wealth in developed economies. The benefit of an altered (lowered) risk profile to an Insured Mutual Fund is shown in Figure 3 below.

Figure 3. – PAYOFF AND RISK PROFILE TO INSURED MUTUAL FUND

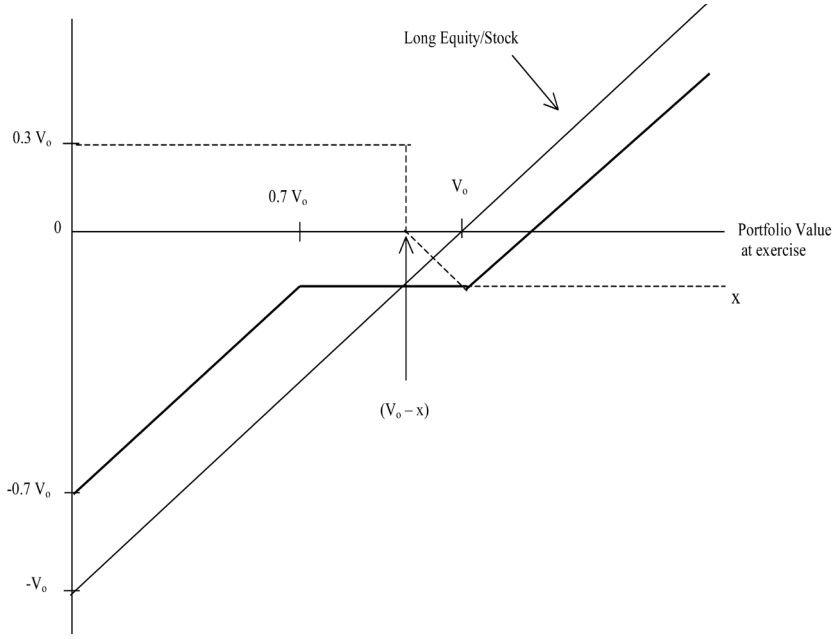


Figure 3 shows the payoff and risk profile to an insured Islamic Mutual fund. The solid line that passes through V_o and ends at $-V_o$ represents the payoff to the original long stock or equities position. It also represents the payoff to the *unhedged* position. The dotted line denoted x which ends at 0.3 V_o is the mirror opposite of the payoff to IEGC (shown in Figure 2). At any point to

the right of V_o, (when value is rising), the insurance is worthless and therefore has a net cost of – x. At any value below V_o, the insurance begins to be valuable. At any point to the left of (V_o – x), the insurance is worth exercising. The maximum profit from exercising the insurance is reached at 0.3 V_o, which reflects the fact that the insurance is capped at 30 per cent of the total fund value. The bold line shows the payoff to the overall insured position. It is derived by aggregating the dotted line x and the long equity payoff line. Thus, at any point to the left of (V_o – x), the insurance scheme is always superior to the unhedged position. To the right of that point however, the insured scheme produces a return lower than the unhedged long equity position by the amount of the premium.

Mutual fund investment being a mudarabah arrangement, the individual investor has little recourse if a mutual fund makes losses. Any stability in mutual fund returns directly benefits its investors. In addition to more stabilised returns, individual investors also benefit from the monitoring services of the IEGC. As the agency continuously monitors mutual funds for changes in the risk profile of its insured funds, investors benefit from the scrutiny. The mere fact that an external party is monitoring their activity can tamper a fund manager's behaviour. This adds another layer of safety to the preservation of their wealth.

The final question that remains is why should Islamic Mutual funds be willing to join such an insurance scheme? Obviously, participation will mean increased operational costs. Aside from the cost of the insurance premium, there will be higher administrative costs in line with the need for additional compliance. Given these, it would appear that it would not be in the interest of a fund manager to participate. However, even without government fiat, it would be possible to get most funds to participate if, as in the case of the FDIC, participation is seen as an official stamp of approval and of government backing. When investors are shown as direct beneficiaries, market forces would ensure participation of the mutual funds. As investors gravitate towards the insured funds, it will be in the interest of the uninsured to participate.

5. Conclusion

The objective of this paper was to make a case for wealth preservation through risk management. It provided an exposition of risk management techniques used in conventional finance and outlined the limitations faced by Muslim fund managers and businesses. This limitation arises from the proscription of the key set of risk management tools; namely financial derivatives. Though the reasons for proscribing derivatives are varied, the overriding concern appears to be that they encourage speculative behaviour. As such, the emphasis of Islamic risk management has been on On Balance Sheet Methods, such as diversification and asset-allocation in the case of equity risks and methods such as exposure-netting, pricing strategy and CRSA in the case of currency

exposure. The problem with On Balance Sheet Methods is that they require the restructuring of business transactions which can render businesses less competitive and subject to residual risk.

The paper goes on to propose a portfolio insurance scheme where Islamic Mutual funds would be able to buy the equivalent of Index Put options from a centralised agency. At the heart of the proposal is the need to strike a balance between the key concern of Shariah scholars, which is to prohibit speculation and the genuine hedging need to preserve Muslim wealth.

In avoiding speculative behaviour but enabling risk management, value is preserved. One should bear in mind that a failure to manage risk is not just imprudent, but value destructive. Risk reduction, aside from stabilising returns, can be value creating. As risk is reduced, the required returns for an investment reduces. For a given cash flow, the investment increases in value as required returns fall. Thus, risk management can be not only wealth preserving but also wealth creating.

One would be tempted to ask if the proposed scheme has real world precedence. The answer is yes. Indeed, there are several institutions that already play the same role as the proposed IEGC. The FDIC, which has already been mentioned, is one. Another would be the Pension Benefits Guarantee Corporation (PBGC) also of the US.

In a sense, even within stock markets, market makers and specialists who are required to buy when stocks are falling are also playing a similar role. They however, assure liquidity, not value. Their similarity with the IEGC is that they too would end up going with long (buying) stocks during down markets. Their survival has depended on their ability to manage their risks. The ability to use derivatives to manage their risk has obviously made their task easier. Finally, the proposed equity insurance is really not very different in risk profile terms from the credit guarantees that Islamic Banks routinely provide for their customers. In providing a credit guarantee, a bank is essentially providing a *put option* to its customer. Thus, it is no different from the put option provided by the IEGC to Islamic Mutual funds.

In conclusion, the current inattention to risk management, in particular equity risk, can have serious long-term implications on the overall economy. The inability to hedge equity risk and the resultant losses would cause money to flow away from Capital Markets and into non-tradeables such as real estate or worse, gold, jewellery and the like. This stunts capital market growth, denies businesses easy access to capital in order to grow and allocates resources into non-tradeable assets, which are amenable to asset bubbles. Money capital goes not into producing goods, but into "safe" but "dead" assets. The result would be a prohibitively high cost of capital for businesses, rendering the overall economy uncompetitive. Thus, there is an economic and social cost to ignoring risk management.

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Al Wakalah and its Impact on the Growth and Performance of *Takaful* Companies: A Malaysian Case

Abstract

Marketing Islamic insurance (*takaful*) products does not imply exploiting the religious factor alone. Equally important is the marketing channel. As a marketing tool the agency system is vital. Insurance agents who sell policies are not employees of insurance companies. They work on a commission basis and thus are motivated by the volume of sales made. By using agents, insurance companies can cut overhead costs and help expand markets without using or setting up new costly subsidiaries. The first takaful company in Malaysia, Syarikat Takaful Malaysia Berhad (STMB), does not use the agency system (*al wakalah*), in contrast to the second company, Takaful Nasional Sendirian Berhad (TNSB). The different marketing channel used has a lot to do with both companies following different Islamic scholars' views of the al wakalah contract. It centres upon differences in juristic interpretation (*iktilaf*) on whether the takaful company, as a manager (mudharib), can use part of the capital, in terms of premiums provided by the policyholders (*rabulmal*), to pay agents' commissions. This study looks at how this difference in juristic views has impacted the performance of both takaful companies. The study found that TNSB performed better than STMB. In this sense, al wakalah is able to generate greater benefits (*manfaat*) than the takaful companies while not causing harm (*madarrah*) to the customers. It is therefore crucial for STMB to review its policy on al wakalah and embrace the system to improve its performance.

1. Introduction

There are a number of issues in the *takaful* industry that warrant serious research both in theory and practice. Earlier, attention was mostly focused on questioning the content of uncertainty (*gharar)* and gambling (*maisir*) in *takaful*. *Gharar* can mean many things such as pure or natural risks as well as risks arising from human deliberate action and likewise, gambling and aleotary contracts deal with the outcomes that arise from pure chance. Further debates dwell on the re*takaful* issue and the *takaful* model that uses the principle of *mudharabah* in the investment of *takaful* funds.

* The authors would like to thank the editor and the referees for their reviews and comments on earlier drafts of this paper. An earlier version of this paper was also presented at the International Islamic Banking Conference, Italy, in September 2003. Comments received at the conference are also duly acknowledged.

This paper deals with the last issue where *mudharabah* is applied in managing *takaful* funds. Since the promotion of *takaful* products can be carried out by agents as well as owners, Islamic law (*Shariah*) legitimacy depends on the nature of the *takaful* model adopted by the company. If the model is based on *mudharabah,* there is a disagreement over the use of agents in product marketing. However, the agency system (*al wakalah*) is an important aspect of the insurance business as it greatly aids the marketing and distribution network at minimum cost. If juristic differences arising from *iktilaf* have thwarted the function of agents, it is important to see how this has impacted the performance of *takaful* companies that go against the agency system. Likewise, it is also interesting to see the performance of *takaful businesses that apply the system.*

Two takaful companies in Malaysia, in which one supports the system of agents while the other rejects it, were chosen for this study. First, by using trend analysis, the study examines the growth of *takaful* funds in these two companies over time. Greater expansion of the *takaful* business may imply more market share. Since they sell similar products, greater market share may be caused by an efficient marketing system that is either through *al wakalah* or a subsidiary network. Second, the study uses financial ratios to measure each company's performance. Profitable operations can be due to lower overhead expenses. Refusal to adopt *al wakalah* may increase capital expenditure, which in turn decreases profit, since the *takaful company is required to set up new subsidiaries across the country to increase distributions.*

The remainder of this paper is organised as follows. The next section provides a brief introduction of the two companies. The third section begins by examining the concept of takaful with an illustration of the *takaful* model being used in Malaysia. The section continues by looking into the debates and misconceptions of insurance in Islam as well as highlighting the differences between *takaful* and the conventional insurance. The fourth section deals with the contract of *al wakalah* and the discussions of juristic views on the application of *al wakalah* in *takaful*. In the fifth section, results of trend and financial ratio analysis based on both companies' financial statements are presented. The final section concludes.

2. Companies' Background

At the time of the study, there were two *takaful* companies in Malaysia.[1]The first, *Syarikat Takaful Malaysia Berhad* (STMB), is a public listed company and a subsidiary of BIMB Holdings *Berhad* (BIMB Holdings).[2] It was established in 1984 and is the pioneering company in the industry. Its main ob-

[1] Two new companies, *Takaful Ikhlas* and Mayban *Takaful*, have since been established.
[2] BIMB Holdings also owns Bank Islam Malaysia Berhad (BIMB), the first Islamic Bank in Malaysia to be given the license to operate according to the requirement of the *Shariah*.

jective is to provide *takaful services at the highest standard of efficiency and professionalism to all Muslims and the population in the country.*

The other is Takaful Nasional Sendirian Berhad (TNSB), unlisted and a subsidiary of Malaysia National Insurance (MNI) *Berhad*. It began its *takaful* operation in 1993, with the birth of MNI *Takaful Sdn Bhd*.[3] In general, it is set up with the same set of objectives as that of STMB, and in particular, to provide insurance based on the *Shariah principles, as an alternative to the conventional insurance. Also of importance is that it provides the industry with an alternative and the desired level of competition, which was lacking prior to its establishment.*

The companies' principal activities are in the provision of Family Takaful, life insurance in the conventional sense and General *Takaful*, equivalent to the conventional general insurance schemes. Apart from having very similar objectives and principal activities, both companies also mirrored one another by having similar organisational structure, target segments and markets and available *takaful* products within the family and general businesses. On the investment front, by being an Islamic Financial Institution (IFIs), their investment portfolios are limited to those that are not against the *Shariah*, such as the *Shariah* approved counters, the Islamic bonds, the Islamic banking investment products and the Government Islamic Investment Certificates.

It can be said that a potential participant[4] would not be able to tell the difference between these two competitors, besides the fact that STMB has been in the market longer.[5] Nonetheless, there is a very distinctive difference in the mode of operation between the two companies, particularly in the area of attracting and servicing *takaful* participants. That distinguishing feature is due to the non-employment of any *takaful* agents by STMB in selling and marketing their *takaful* products. STMB expects any interested potential participants to come personally to its counters to buy its policies (plans). This is in complete contrast to what TNSB does, where it is utilising agents, in a similar mode to that of most conventional insurance companies.

Before the rules and principles of *al wakalah* and its impact on the *takaful* companies are examined, an enlightenment of the *takaful* concept in Islam would ease the understanding of *al wakalah* and its relation to *takaful. This will be reflected in the next section.*

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[3] MNI *Takaful* changed its name to *Takaful* Nasional on the 8th December 1998.

[4] For this paper, the word 'participant' is synonymous with the word customer and/or insured, and they will be used interchangeably. They represent the segment of the public who are present and/or potential owners of the *takaful* plan(s). This remains valid unless a statement to the contrary is made.

[5] This fact was mentioned during interviews conducted with the respective companies' financial managers.

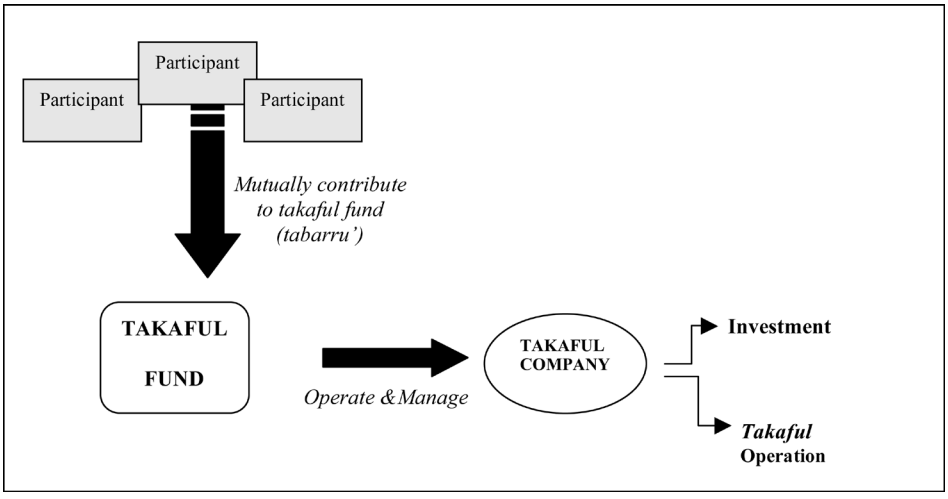
3. The Concept of *Takaful*

Takaful stems from the Arabic verb *kafal* which literally means to take care of one's needs, and it is the term used to describe insurance that is in compliance with the *Shariah*. The Malaysian *Takaful* Act (1984: 78) defines *takaful* as "a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose." In other words, as Rosly (1996) stated, the basic objective of *takaful* is to pay for a defined loss from a defined fund.

The concept of *takaful* had already existed during the time of the Prophet, peace be upon him, where the Muslims contributed to a fund called a*l kanz* under the Islamic system of *aqila* (Billah, 2003). The contribution was for the purpose of helping members of their own community who were liable to pay *diyat*[6]. The system of *aqila* as practised among the *Muhajirin* and *Ansar* tribes in Medina was often said to lay the foundation of *takaful* since *aqila* implies mutual help and support which can also mean to guarantee each other on moral grounds. However, it must be understood that the system of *aqila* is non-commercial in nature and aims to help those in difficulties without demanding contractual payments.

In Malaysia, the modus operandi of the *takaful* system in general is presented in Figure 1. There is a two-tier relationship in the *takaful* contract that is external in nature to the *takaful* company.

Figure 1. – ILLUSTRATION OF THE TAKAFUL SYSTEM IN MALAYSIA



Source: Nordin and Omar, 2000

[6] Diyat is a system of blood money practised by pagan Arabs but later adopted and refined by Islam.

The first tier is amongst the participants themselves, based on gratuity or donation (*tabarru'*). A certain proportion of the participants' premiums are relocated to pay fellow participants' claims with the balance of the premiums being used for the purpose of savings.

The second tier is amongst the participants as one entity (i.e. the fund) and the *takaful* company. STMB and TNSB apply the *mudharabah* contract besides being the trustee in describing their relationship with the participants. Both these companies regard the operation of *takaful* as a commercial enterprise or *takaful at tijari*.

A slight amendment to Figure 1 is required when one considers TNSB's operation taking into account the agency system in use. This additional entity will come in between the participants and the *takaful* fund as the agents act as the intermediaries. Although the agents present a new entity, the external second tier relationship, as opposed to a new tier relationship, still prevails as the agents are acting only on behalf of the company. However, there still exists an internal relationship between the agents and the company (the principal), and it is the objective of this paper to explore this particular relationship, as will be made clear in the next section.

3.1 Misconceptions and debates on the permissibility of insurance and *TAKAFUL*

The definitions and concepts of *takaful,* stated previously, are exactly the same with mutual insurance as was practised in the early days of insurance and even today by certain quarters. Due to this, many parties, including conventional practitioners and renowned Islamic scholars, have questioned the assertion that *takaful* and insurance are different and consequently, whether it is acceptable in Islam. A number of people from the conventional insurance industry have remarked that since both schemes are using the concept of the fortunate many, helping the unfortunate few, the difference is rendered to be only superficial in nature, referring only to the difference in the naming of the scheme. However, they fail to realise that the argument goes beyond the concept itself, spanning into the spheres of rules and the nature of contracts in Islam. The majority of Muslim jurists do not argue whether the concept of the common pool is contravening the *Shariah* precepts or not, but are objectionable towards certain elements within the insurance contract, whereas *takaful* is not guilty of the same. Moreover, Muslim jurists are also unconvinced that the conventional insurance, with the exception of mutual insurance, is truly a venture of a cooperative sense based on the notion of brotherhood, solidarity, and mutual assistance. The conventional insurance scheme is seen to be motivated by self-interest and material gain, facets that have no place in *takaful* (Tardmidzi, 2000).

A renowned Islamic scholar aptly sums up the position of the jurists when he says (Qaradawi, 1985: 276):

> "*Our observation that the modern form of insurance companies and their current practices are objectionable Islamically does not mean that Islam is against the concept of insurance itself: not in the least – it only opposes the means and the methods. If other insurance practices are employed which do not conflict with Islamic forms of business transactions, Islam will welcome them.*"

What Qaradawi said above can be interpreted as being that Islam accepts whatever is good and does not go against its teaching, which suggests that certain systems, such as insurance, should not be totally redesigned from scratch in order to be called Islamic. This is also in accordance with the saying of the Prophet, peace be upon him, when he said that "the virtues of the *Jahilliyya* are acted upon in Islam" (Muslehuddin, 1982: 23).

However, there also appears to be differences in opinion and certain misunderstandings on the validity of the concept of insurance and *takaful* among the Islamic jurists. Billah (2003) has identified three different groups as a result of these different views and the classification is reproduced below:

(i) the first group believes that insurance practice is entirely and absolutely lawful provided that it is free from the element of *riba*.

(ii) the second group comprises some Islamic scholars who accept general insurance, but object to life as it involves the element of *maisi*r (gambling) and *gharar* (uncertainty).

(iii) the third group totally rejects any practice of insurance on the grounds that it involves the elements of *riba*, *maisir* and *gharar*.

Apart from the elements of usury, uncertainty and gambling or betting, other elements which have been argued to render insurance invalid include that insurance is contrary to the principles of *tawakkul* (putting trust only in God), *mirath* (inheritance), *wasiyah* (beneficiary) and *takdir* (will of God).

In refuting these misconceptions, Billah (1996) has clearly demonstrated how these misconceptions should be seen from two different angles, in terms of the concept of insurance and in terms of the elements within insurance that make conventional insurance unacceptable to Islam. As discussed earlier, the concept of insurance of the fortunate many, helping the unfortunate few, does not run foul of the *Shariah*. Hence, the attention now turns to the elements which differentiate both schemes. The first element which is being disputed is usury (*riba*). In an insurance scheme, *riba* could occur in two different instances. Firstly, *riba* could occur through the non-*halal* (non-permissible) earnings acquired, such as interest received upon returns from investments in banks or other companies that are not approved by the *Shariah*. In *takaful*, the returns are of *halal* earnings due to the fact that *takaful* companies are allowed to invest only in activities or areas approved by the *Shariah*. The

Shariah Advisory Council (SAC), an independent committee of a *takaful* company, made up of people with expertise in the *Shariah*, ensures this governance aspect of *takaful* investments.

Secondly, *riba* could take place at the time when claims payments are made by the company to the claimants. Two types of *riba* occur here, i.e. *riba al-nasiah*, *riba* by virtue of deferment at the time of exchange and *riba al-fadl*, *riba* by virtue in excess in terms of the quantity of one of the counter values. These two definitions of *riba* are based on the *hadith*[7] of the *ribawi* items reported on the authority of 'Ubadah b. al-Samit (as quoted by Bakar, 2000c: 6) that is:

> *"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, equal for equal, and hand to hand. If the commodities differ, then you (may) sell as you wish provided that (the exchange) is hand to hand."*

Although the *hadith* does not specifically mention money as one of the types of commodities, scholars have agreed that of the six commodities, two (gold and silver) unmistakably represent commodity money (Bakar, 2000c). Consequently, the term 'money' as we know today, either in paper or electronic form, falls under the jurisdiction of this *hadith*. Hence, the insurance scheme, at the time of claims payment, lacks these two conditions. *Riba al-nasiah* occurs because of the lapse in time between periodic premium payments and claim payments, i.e. it is not immediately exchanged (hand to hand). *Riba al-fadl* on the other hand, takes place because of the different counter value between the amount periodically paid as premiums and the total compensation paid in one lump sum.

In this instance, *takaful* works the same way as insurance. However, it does not run foul of *riba al-nasiah* and *riba al-fadl* due to the different terms of the contract entered into between the participants and the company. The fundamental difference lies in the fact that in *takaful*, the premiums are paid on the basis of *tabarru'*.[8] This changed the contract because with *tabarru'*, it is the participants who are carrying the risk and not the company. The company is clearly not the owner of the funds but only its trustees in acting on behalf of the participants in managing the funds. Hence, the company does not have any right to the *takaful* benefits and surpluses and cannot use the premiums except as intended by the participants, which is for mutual help and investments in *Shariah* approved activities. As compensation for managing the funds, the companies will either be paid agency fees or share in the profits made from investments of the funds using the concept of *mudharabah*.[9]

By including the sincere intention of *tabarru'* into the contract, the element of *riba* is eliminated. This is because with *tabarru'*, the contract is no longer

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[7] The sayings of the Prophet, peace be upon him

[8] *Tabarru'* is an Arabic noun that means donation, gift, or contribution.

[9] STMB and TNSB chose the latter.

that of an exchange of goods i.e. money with money – premiums with sums insured – such as the contract of conventional insurance, but that of gratuity or donation. Hence, since the claims payments were derived from the sincere contributions of solidified participants, the differences in the time of exchange and in terms of the counter value become immaterial. In the *takaful* proposal, forms completed by the potential participants for the purpose of evaluation, the word *tabarru'* is clearly mentioned and thus becomes the basis of the contract. One of the functions of the proposal form is to enable those who wish to participate in the *takaful* scheme to offer (*ijab*) themselves for inclusion. If the proposal is accepted (*qabul*) by the company, then a contract (*aqad*) materialises.

The second controversial element refers to the element of *gharar*. Certain scholars, particularly those of the *Shafi'is*, upheld that insurance contains *gharar*, and thus any transactions involving *gharar* would render a contract null and void. *Gharar* could take place in three instances. Firstly, it could mean uncertainty in either the object or the subject matter of insurance. Billah (1996) refuted this contention by making it clear that an insurance contract does not involve the elements of *gharar*, because the subject matter is definite, being either the life or property on which the risk is presumed to be occurring in the future. This is a similar situation facing *takaful* and that would make it lawful as well. The second and the third instances of *gharar* differentiate conventional and *takaful* schemes. The second instance where *gharar* may occur is on the uncertainty of the future occurrence of the risk. This claim can be refuted by basing upon the *tabarru'* factor, explained earlier under *riba*. Other than the *Shafi'is*, other scholars from other schools of Islamic jurisprudence had maintained that for contracts that are based on gratuity, such as *takaful*, *wassiyah* and *hibah*, the element of *gharar* will be eliminated. Thirdly, *gharar* could refer to the uncertainty in the amount that will be paid out when and if the future risk occurs. Unlike insurance, where the compensation amount is determined in advance, in *takaful*, the actual amount will only be known when claims are made. The claims amount will not only depend on the ability of the policyholders to pay the premiums amount, but also on the actual profits or dividend shared during the policy period up to the point of claims. Rather than this being uncertain, it follows an important principle of the *Shariah*, that the future amount is unknown and depends on the will of *Allah* (s.w.t) in determining the luck and destiny of one's life.

The third factor that is being debated is the element of gambling or betting. Gambling is strictly prohibited by *Allah* (s.w.t.) since a gambler hopes upon a chance to obtain a material gain after paying a certain amount of money. According to Billah (2003), some scholars argued that insurance displays a similar attribute, as the insured pays the premiums with the hope of obtaining a handsome return. He argued that what these scholars fail to see is that an insurance policy (and *takaful*) does not contain this element since the

scheme is based upon cooperation of participants that are bound together in a spirit of mutual help and goodwill, instead of hoping to beat one another, as is the case with gambling.

Another way that gambling could occur originates from the point of view of the company, which is contrary to the insured point of view given earlier. The company, after receiving the premiums from the insured, would hope that a minimum of claims are made so that they have a bigger surplus and higher profits. This point is true for conventional insurance schemes as the fund's surplus belongs to the company. *Takaful*, however, does not show this characteristic because as was mentioned earlier, the funds' surplus does not belong to the company. It belongs to the participants, with the company simply acting as a trustee in managing the funds. Hence, in *takaful*, the company shares in the returns from investments of the fund but not from the surplus of the funds.

Insurance schemes are also alleged to be inconsistent with the principles of *mirath* and *wasiyah*. In insurance, whoever was nominated by the insured as the nominee is the absolute beneficiary. That means the heirs of the insured, after his death, will be deprived of their rights to inherit a part of the deceased's wealth. Although this may be true for conventional insurance, in *takaful*, the nominee is not the absolute beneficiary, but acts only as a trustee on behalf of the heirs and will only receive part of the wealth if he or she happens to also be a legal heir (Billah, 1996).

Finally, some scholars think that insurance violates the principles of *tawakkul* and *takdir*, and as such should be unacceptable in Islam. However, according to Billah (2003), insurance is neither putting trust in other than *Allah* (s.w.t.) nor superseding His will. Rather, insurance and *takaful* simply means that both the company and the participants mutually agree to work for a compensation or security against an unexpected tragedy. This is carried out in all sincerity with no intention of overcoming the trust placed in *Allah* (s.w.t.).

From the explanations above, it is very clear that the concept of insurance is very much in line with the teachings of Islam. *Takaful* works on a similar concept and moreover, the elements that make the conventional insurance permissibility to be highly debated among scholars, are absent and hence this would provide Muslims with a way of either protecting themselves or their heirs against losses brought about by unforeseen calamities or savings for old age, without the fear of going against the *Shariah*.

4. The Contract of *Al Wakalah*

Before going into the analysis, it is necessary to have a brief and clear understanding of the underlying concept of al wakalah in Islam.

Al wakalah is a term built on the root word *wakala*, which appears in the *Qur'an* in several places and bears several meanings. Despite that, they are all

used to indicate a representation of a person on behalf of another person in certain dispositions, and as Napiah (1995) stated, it could mean to be either *al hifz* (to preserve or to defend), or *al tafwid* (to entrust) or to be responsible for arranging one's affair. The *Majelle*[10] (2001: 239) provides the definition of agency to be:

> "*…when someone puts business of his on another and makes him stand in his own place in respect of the business.*"

The *Qur'an* contains several verses that deal with the lawfulness of *al wakalah*. None of the verses directly testifies its permissibility though, and it was through the process of *ijtihad* that the Muslim jurists were able to relate the verses to the concept of *al wakalah*. The most significant verse representing its permissibility is the following:

> *"…Now send ye then one of you with this money of yours to the town, let him find out which is the best food (to be had) and bring some to you, that (ye may) satisfy your hunger therewith…"*[11]

This verse relates to the episode whereby one person was appointed among the Companions of the Cave, to go to the city to buy food with their silver coin.

Another verse that proves the legitimacy of *al wakalah* is translated below:

> *"Go with this my shirt, and cast it over the face of my father: he will come to see (clearly). Then come ye (here) to me together with all your family."*[12]

This verse describes the order that came from the Prophet Joseph to his brothers, and to some jurists, which is akin to *al wakalah*. Apart from the *Qur'an*, sources of the legitimacy of *al wakalah* can be found in the s*unnah*[13] and h*adith* of the Prophet, peace be upon him. A*l wakalah* was commonly practised in the early period of Islam. The Prophet, peace be upon him, had in fact been directly and indirectly involved and encouraged the proliferation of the activity.

Napiah (1995) said that a *hadith* reported by Abu Dawud, Al Baihaqi, al Dar Qutni and al San'ani provides further proof of the recognition and approval of the Prophet, peace be upon him, on the legality of the practice of *al wakalah*. The *hadith reported an event whereby the Prophet, peace be upon him, addressed Jabir b. Abdullah who was about to go to Khyber. The Prophet, peace be upon him, said*

> "*If you meet my agent, take or ask from him fifteen wasq*"

It is known too that the Prophet, peace be upon him, commonly appointed agents to perform certain duties on his behalf. One of the duties is the collec-

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[10] The Majelle or Majallah al Ahkam al' Adliyyah, the foremost authority on *Shariah*.
[11] Yusuf, A. (1997: 712).
[12] Yusuf (1997: 577).
[13] The actions of the holy Prophet, peace be upon him.

tion of alms (zakat), and it was narrated in a *hadith* by Abu Hurairah that the Prophet, peace be upon him, sent Caliph 'Umar for this purpose. In all these instances, the assistants chosen by the Prophet, peace be upon him, acted out the disposition in the form of *al wakalah (Napiah, 1995).*

The contract of al wakalah or agency falls under the realm of the concept of representation or deputation (*al niyabah*). The idea of deputation was established in its complete and comprehensive form in Islamic law, together with the birth of the *Shariah*, whereby in contrast, the same concept of deputation in the west, which is based on Roman law, derives its complete form only in stages (Napiah, 1995). This fact is consistent with other concepts or contracts pertaining to Islamic commercial law and transactions where all regulations and rules must be derived from the *Qur'an* and the *Sunnah. Also, Muslim jurists have deliberated on this matter and have progressed to an advanced level, earlier than other scholars did. Napiah (1995: 40) highlighted a statement by Al Sanhuri to illustrate how definite Islamic law is in this field of deputation. Sanhuri states:*

> *" Islamic jurisprudence is extremely cautious and can be distinguished from Western jurisprudence by its advancement in promoting the idea of deputation in the formulating of contracts. It excelled over the Roman jurisprudence, which was known for its scarcity in this field, as has been seen."*

4.1 Effect of juristic views on the marketing channel used

IFIs are bound to operate their businesses within the precept of the *Shariah*, the knowledge sourced from divine revelations. The revelations contain two categories of knowledge, which can be classified as either specific or general. Many of the specifics and detailed rulings govern the area of interactions between man and God, whereas many of the general principles are that of between man and man, which include business transactions. The general principles, being not specific, would have to undergo the process of *ijtihad* before they can be utilised according to current times and situations. As there are many ways and methods of understanding the *Qur'an* and *sunnah*, there would inevitably be disagreement among scholars and these varieties are well documented in the legacy of Islamic law particularly in the writings of all major schools of Islamic law. There were several legal systems called *madhab*, corresponding to different methods of conducting jurisprudence, which usually differed with regard to the details of practical application (Bakar, 2000a). Currently there are four *madhabs,* each named after its founder, and all four legal systems impact the strategies and operations of IFIs in Malaysia.[14]

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[14] They are, in the order of time (beginning with the oldest), the *Hanafi*, the *Maliki*, the *Shafi'i* and the *Hanbali*. Results of the interpretation between them vary, from total disagreement to total conformity. With regards to areas of disagreement, the differences are in the application and not the roots of the *Shariah*, hence all views are considered right and none is to be question, which gives rise to *iktilaf.*

Within the *takaful* circle, many of those involved in the industry have heard various reasons, which tried to explain the rationale behind STMB's decision of not using agents. Not much concrete evidence can be found to clearly explain STMB's stand, making the issue vague and not as clear-cut. A significant indication to represent STMB's decision is best derived from a book on *takaful* that it published (Yusof, 1996: 20).

> *"According to the Encyclopaedia On The Theory and Practice Of Islamic Banking (al-Mausu'ah al-Ilmiyah Wal-Amaliyah Lil-Bunuk al-Islamiyah), published by the International Association of Islamic Banks, it is prohibited to deduct management expenses from the al-Mudharabah capital or its realised profit. The takaful contribution is the Mudharabah capital provided by the participant, therefore the capital or its investment profit cannot be used to pay for financing the agency system (al wakalah) in view of the fact that agency cost is a component of the management expenses which should be borne by the operator."*

A couple of things emerge from the statement above. Firstly, the main contention lies in management expenses, where the agency cost in the form of agents' commissions, are part of the expenses. As such, the stand that STMB took resulted not from the employment of agents or directly due to the agency per se, as an agency is permissible in Islam as explained earlier, but rather on the treatment of the cost of the agency, i.e. who should bear the costs. STMB argues that because of the prevailing *mudharabah* contract that governs the relationship between the company and the participants, it cannot use the capital, in the form of premiums, as well as the profits made through investments of the capital, to remunerate the agents.

Secondly, by referring to the encyclopaedia instead of to divine primary sources of knowledge, this issue is thus an issue of interpretation (*fiqh*) of the *Shariah*, which is *ijtihadi* in nature. By following a certain juridical interpretation or ruling governing management expenses, STMB has decided to forgo the implementation of *al wakalah*. This is a classic example whereby the operating strategy of a company is constrained by adherence to a particular ruling of one of the legal schools of Islamic jurisprudence. Comparatively, this would mean that TNSB, in employing the agency system, complies with the ruling of other legal schools, for it would be constrained too, if it were to follow in the footsteps of STMB.

Muslim jurists are divided over the issue of the management expenses incurred in a business. According to Bakar (2000b), the *Shafi'is* view is that covering such expenses from the *mudharabah* capital or its realised profit will lead to the element of *gharar* (uncertainty) and the presence of *gharar* makes the contract void. It is apparent that the concept of STMB on management expenses is based on this view. On the other hand, the other schools of law have held the view that expenses can be deducted from the business account or realised profits depending on the nature of the expenses. The *Hanafis* and

Malikis would confine the permissibility to the case of journey and its related expenses to cover both the lodging and food. The *Hanbalis*, on the other hand, does not limit it to the case of a journey whereby the manager (*mudharib*) may deduct his management expenses from the account even during his stay in his hometown. These expenses are related to necessary expenses such as food, clothing, lodging, salaries of employees and the like, but must be at the standard norms of the society or industry. Also according to the *Hanbalis*, all expenses must be deducted from the gross profit, if any, and in the event of no profit, it could be reimbursed from the capital. Therefore, it is clear that TNSB concurs with the other schools besides the *Shafi'is*.

The effect of the above can be seen from the annual reports of the companies. In the case of STMB, all expenses other than the *takaful* funds common expenses[15] are solely borne by the company. In contrast, TNSB charges agents' commissions and those expenses that are directly attributable to the *takaful* funds, against the *takaful* funds. These expenses are other than the funds' common expenses. That leaves only those expenses not directly attributable to the *takaful* funds to be borne by the company in the profit and loss accounts.

In Malaysia, the majority of Muslims usually conform to the *Shafi'is* view on devotional matters. However, on matters which concern business transactions (*muamalat*), Muslims tend to take various views including from the other schools. According to Bakar (2000a), the legal theory developed by the *Shafi'is* is best for areas of law which are fixed such as devotional matters because this school of law was never involved in areas of law which are flexible and worldly-oriented such as that of business transactions. Consequently, STMB can adopt other views for the implementation of *al wakalah*.

Having raised these points, the question would be why STMB should implement the system, as it is all right, at least by the *Shafi'is* interpretation, if it decides not to use agents. The answer to this question is that agents improve the performance and growth of a company as shall be shown in the following section.

5. Accounting Standards for Insurance and *Takaful* Companies

In Malaysia, the Malaysian Accounting Standards Board (MASB) principally governs the financial reporting of insurance companies.[16] However, since standards for *takaful* companies are still under construction, both TNSB and

[15] *Takaful* funds common expenses include claims, maturity and surrender values of certificates. The balance left after deducting these expenses is called surplus and unlike conventional insurance, it belongs to the participants, not the company.

[16] MASB 18 deals with life insurance business while MASB 17 with the general insurance business. MASB 18 supersedes MASB Approved Accounting Standard MAS 4, Accounting for Life Insurance Business. MASB 17 supersedes MASB Approved Accounting Standard MAS 3, Accounting for General Insurance Business.

STMB prepare their financial statements according to the conventional standards with modifications made to comply with the *Shariah* requirements.

Apart from these, insurance and *takaful* companies in Malaysia are also obliged to follow the Accounting Guidelines issued by the central bank, *Bank Negara Malaysia* (BNM) as well as to comply with the provisions of the Companies Act, 1965. Further references need to be made to the Insurance and *Takaful* Acts and they are also encouraged to adopt the International Accounting Standards (IAS) recommended by the International Accounting Standards Committee (IASC). For *takaful* companies, further recommended standards are the Accounting, Auditing and Governance Standards for Islamic Financial Institutions developed by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). All of these standards and guidelines set out the proper accounting treatment for various aspects of the insurers' operations in Malaysia, such as premiums (contributions), investments, claims and reinsurance (*retakaful). They also provide guidelines on the general presentation and disclosure in the financial statements of both Islamic and conventional insurance companies.*

One of the most noticeable modifications to the accounting standards and guidelines above is the revenue recognition policy practised by STMB and TNSB. STMB accounts all revenue, including contribution revenue, on a cash basis, i.e. only when payment is received, whereas TNSB recognised contributions using an accruals basis with other revenues, such as the returns on investments, on cash. These practices are in contrast with the practice of recognising premiums and other income, on an accrual basis, as accorded by the accounting standards and guidelines.

The argument to opt for a cash basis is based on the interpretation of the *mudharabah* contract governing the relationship between the company and the participants. STMB contended that profit can only be shared and distributed based on the actual receipts, which can only be done using an accounting practice based on cash (Yusof, 1996).

A written correspondence from a senior official of BNM revealed that BNM allows the use of both a cash or accruals basis in recognising contributions and other revenue, although it is moving towards the accrual basis to be consistent with AAOIFIs and IAS.

5.1 Importance of financial statement analysis

Public confidence in the *takaful* companies depends, to a large extent, on the information that they disseminate. AAOIFI (1999) noted that various stakeholders[17] with diverse interests and concerns, common or unique, make up

[17] The main categories of users or stakeholders include equity holders; participants; others who transact with the takaful operators, who are not equity holders or participants; zakah agencies; regulatory agencies, employees and the public at large.

the different segments of the interested public and they rely mostly on the annual financial reports that these companies produced in order to make informed decisions. Financial accounting and reporting plays an important role in directing economic resources in society as a result of the decisions made by the users of the reports, who rank financial accounting and reporting as the basic information required for decision making.

Comparing the performance between the companies presents one of the ways of the process of decision making, by aiding the stakeholders' choice of investing or dealing with one *takaful* company versus the other. To enable comparisons, it is vital that the presentation and reporting practices of the two *takaful* companies be standardised and hence, comparable. According to Elliott and Elliott (2000), besides comparability, standardisation will also result in attaining three other principal qualitative characteristics of financial reporting, namely, relevance, reliability and understandability. Nobes (1998) argued that major differences in the financial reporting practices of companies' will lead to great complications for those preparing, consolidating, auditing and interpreting published financial statements.

This is true when it comes to the annual financial reports of the STMB and TNSB. The main difference lies in the treatment of revenue recognition for the contribution paid by the participants, for both family and general *takaful* funds. Prior to the analysis, adjustments were made to the contribution figures of TNSB. TNSB recognised its contribution based on the accrual basis, while STMB on cash. Hence, for data quality, the contribution figures of TNSB were recast from the accrual to the cash basis of recognition. Recasting TNSB's contribution from an accrual to a cash basis was preferred to recasting STMB's contribution from cash to accrual, for the simple reason that additional data can be easily obtained from TNSB's cash flow statements and in the notes to its accounts.

As stated in the section on companies' backgrounds, the external and internal factors facing both companies are essentially the same, with the only exception being the agency system in place at TNSB. Hence, the results of the financial statement analysis in the following section would provide valid evidence of the impact of the system on the growth and performance of the companies. The results show that overall, TNSB is performing better than STMB, and this can only be due to the agents employed.

5.2 Financial statement analysis

For the purpose of the financial statement analysis, the authors went to both companies to obtain the annual reports from 1994 to 2002. The year 1994 was chosen as the starting year, as this was the year that TNSB entered the business. (Lewis and Pendrill, 1996) also pointed out that it is quite usual to look at a series of about 5 years' results as the firm represented in the earlier years in a

longer time series bears little resemblance to the firm at the end of the period. This is due to the fact that the company's environment will change over time, with the result that performance which was considered satisfactory in the past may no longer be so. Comparatives for financial analysis can be obtained either through time series analysis or cross sectional analysis Hermanson *et al* (1998). Such comparisons or relationships may be expressed as:

1. Absolute increases and decreases for an item from one period to the next.
2. Percentage increases and decreases for an item from one period to the next.
3. Percentages of single items to an aggregate total.
4. Trend percentages
5. Ratio Analysis.

The calculation of absolute and percentage of *ringgit* changes in the statement items or totals is called horizontal analysis. This analysis detects changes in a company's performance and highlights trends. Trend percentages are similar to horizontal analysis except that comparisons are made to a selected base year or period. Trend percentages are useful for comparing financial statements over several years because they dislodge changes and trends occurring through time. Frequently, these percentage changes, whether increases or decreases, are more informative than information obtained from comparisons between absolute amounts. For example, by only looking at absolute amounts, it could be seen that the amounts between different years increased, but through percentage changes, the extent of that increased changes, will be highlighted clearly. The changes could either be increasing at an accelerating rate or at a slower pace, or even at a decreasing rate. Finally, no financial analysis is complete without including some degree of ratio analysis. Ratios describe the relationship between different items in the financial statements. The relative usefulness of each ratio depends on what aspects of a company's business affairs are being investigated. This study would use items 2, 4 and 5 from the above expression in the analysis. Items 2 and 4, which represent the trend analysis part of this paper, will show the growth of the two companies while the ratio analysis will reveal their respective performances over the time period chosen, i.e. from 1994 to 2002.

5.3 Results of trend analysis

This study combined horizontal analysis and trend percentages into one table, with reference to each items being analysed. In this study, certain items from the family and general *takaful* funds derived from the companies annual reports, will be subjected to the above selected analysis. The items are:

1. Family *Takaful* Contributions
2. General *Takaful* Contributions

Table 1.1. – FAMILY *TAKAFUL* CONTRIBUTIONS

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Gross Contributions (RM)	572,100,252	734,785,944	172,458,980	117,601,634	82,909,039	55,407,197	38,709,790	9,623,488	0
Horizontal Analysis:									
Changes in absolute amount (RM)	-162,685,692	562,326,964	54,857,346	34,692,595	27,501,842	16,697,407	29,086,302	9,623,488	na
Changes in percentage (per cent)	-22.14	326.06	46.65	41.84	49.64	43.13	302.24	na	na
Trend Percentages (per cent)	5944.83	7635.34	1792.06	1222.03	861.53	575.75	402.24	100.00	na

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Gross Contributions (RM)	278,686,291	563,572,408	143,035,458	116,085,572	99,684,112	65,835,023	48,603,360	26,811,934	15,557,778
Horizontal Analysis:									
Changes in absolute amount (RM)	-284,886,117	420,536,950	26,949,886	16,401,460	33,849,089	17,231,663	21,791,426	11,254,156	na
Changes in percentage (per cent)	-50.55	294.01	23.22	16.45	51.42	35.45	81.28	72.34	na
Trend Percentages (per cent)	1791.30	3622.45	919.38	746.16	640.73	423.16	312.41	172.34	100

3. Total Assets
4. Operating Expenses,
5. Profit before *Zakat* and Tax.

From the table, it can be seen that the contributions for both companies had increased on a yearly basis. The column that denotes changes from the previous year in absolute amount, with the exception of 2002, indicates the yearly increase. The year 2001 marked a tremendous increase of contributions from the previous year (TNSB: 326 per cent and STMB: 294 per cent). The main reason for these increases was due to the introduction of an annuity scheme, which allows workers to utilise savings from the Employee's Provident Fund (EPF) for the purpose of buying a family coverage plan. This annuity scheme lasted for a year until July 2001, and with the cessation of the scheme, the contributions collected for 2002 decreased, resulting in negative amounts and percentages.

Year by year comparison showed that from 1999 onwards, TNSB had collected more contributions than STMB. This was achieved after only 4 years of starting business. TNSB only began to collect contributions in 1995, a year after being established. The situation was also maintained after the annuity scheme was introduced and subsequently after it was stopped. Analysing further, looking from the column of changes from the previous year in percentage terms, the quantum of percentage changes in TNSB, with the exception of 2002, showed the increase in contribution was at a rate which was more stable than that of STMB. The percentage change exceeds that of STMB in 1999, and even when the annuity scheme was ceased, the decrease in the contribution suffered was lower (TNSB: – 22 per cent and STMB: – 50 per cent). This indicates that not only were the agents able to bring in more contributions, but they were also able to help the company to buffer against a sudden change of policy such as the annuity scheme.

Trend percentages-wise, at the end of the accounting year 2002, the TNSB index indicates a high figure of 5,944 points over the base year 1995, which was the year TNSB began to collect the contributions. This indicates the overall higher growth that TNSB enjoyed due to its use of sales agents.

Unlike family *takaful*, there was no annuity scheme in general *takaful*. The contribution figures and the changes from the previous year in absolute amount showed that both companies were able to increase the level of contributions collected on a yearly basis. The analysis also reveals that for all the years under study, the general *takaful* collected by STMB, in absolute amount, were bigger than the sum collected by TNSB. However, TNSB's performance is not too bad either if another vital statistic i.e., the rate or quantum of these changes is taken into consideration.

From the column of changes from the previous year in percentage, the increases in TNSB occurred at a relatively higher and faster rate than STMB with the exception of 2002. The trend percentages also showed the higher

Table 1.2. – GENERAL *TAKAFUL* CONTRIBUTIONS

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Gross Contributions (RM)	80,370,387	68,792,930	36,465,630	20,053,156	15,046,560	5,861,480	4,032,126	2,149,707	0
Horizontal Analysis:	11,577,457	32,327,300	16,412,474	5,006,596	9,185,080	1,829,354	1,882,419	2,149,707	na
Changes in absolute amount (RM)	16.83	88.65	81.84	33.27	156.70	45.37	87.57	na	na
Changes in percentage (per cent)	3738.67	3200.11	1696.31	932.83	699.94	272.66	187.57	100	na
Trend Percentages (per cent)									

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Gross Contributions (RM)	196,416,677	150,005,039	113,136,975	107,602,150	99,073,101	79,520,690	63,379,848	56,701,050	39,084,889
Horizontal Analysis:									
Changes in absolute amount (RM)	46,411,638	36,868,064	5,534,825	8,529,049	19,552,411	16,140,842	6,678,798	17,616,161	na
Changes in percentage (per cent)	30.94	32.59	5.14	8.61	24.59	25.47	11.78	45.07	na
Trend Percentages (per cent)	502.54	383.79	289.46	275.30	253.48	203.46	162.16	145.07	100

Table 1.3. – TOTAL ASSETS

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Total Assets (RM)	1,856,421,480	1,247,624,459	573,540,058	371,258,863	233,754,564	151,745,509	82,869,669	37,686,753	20,727,789
Horizontal Analysis:									
Changes in absolute amount (RM)	608,797,021	674,084,401	202,281,195	137,504,299	82,009,055	68,875,840	45,182,916	16,958,964	na
Changes in percentage (per cent)	48.80	117.53	54.49	58.82	54.04	83.11	119.89	81.82	na
Trend Percentages (per cent)	8956.20	6019.09	2767.01	1791.12	1127.74	732.09	399.80	181.82	100

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Total Assets (RM)	1,572,180,707	1,302,590,765	726,596,152	589,231,270	437,594,201	420,296,808	298,656,438	202,004,299	150,437,077
Horizontal Analysis:									
Changes in absolute amount (RM)	269,589,942	575,994,613	137,364,882	151,637,069	17,297,393	121,640,370	96,652,139	51,567,222	na
Changes in percentage (per cent)	20.70	79.27	23.31	34.65	4.12	40.73	47.85	34.28	na
Trend Percentages (per cent)	1045.08	865.87	482.99	391.68	290.88	279.38	198.53	134.28	100

Table 1.4. – OPERATING EXPENSES

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Operating Expenses (RM)	77,783,630	57,922,206	39,476,793	26,331,888	18,557,866	13,402,516	7,591,043	2,467,647	42,875
Horizontal Analysis:									
Changes in absolute amount (RM)	19,861,424	18,445,413	13,144,905	7,774,022	5,155,350	5,811,473	5,123,396	2,424,772	na
Changes in percentage (per cent)	34.29	46.72	49.92	41.89	38.47	76.56	207.62	5,655.44	na
Trend Percentages (per cent)	181,419.55	135,095.52	92,074.15	61,415.48	43,283.65	31,259.51	17,705.06	5,755.44	100.00

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Operating Expenses (RM)	57,387,958.00	47,660,771.00	34,410,313.00	24,964,199.00	21,436,479.00	16,382,658.00	13,003,710.00	9,627,344.00	6,901,777.00
Horizontal Analysis:									
Changes in absolute amount (RM)	9,727,187.00	13,250,458.00	9,446,114.00	3,527,720.00	5,053,821.00	3,378,948.00	3,376,366.00	2,725,567.00	na
Changes in percentage (per cent)	20.41	38.51	37.84	16.46	30.85	25.98	35.07	39.49	na
Trend Percentages (per cent)	831.50	690.56	498.57	361.71	310.59	237.37	188.41	139.49	100

growth in the business that TNSB had achieved. Hence, it can be concluded here that sales agents helped TNSB to keep up with the performance of STMB when it comes to the general *takaful*.

The favourable performance of TNSB in its collection of contributions has a positive impact on its total assets. As at year-end 2002[18], its total assets stood at RM 1.8 million compared to STMB, which was only RM 1.5 million. This was achieved in a period of only 10 years, which was only half the period of time of STMB's existence. The rate of change in total assets from the previous year in percentage term is very much at the upper end of the scale for TNSB. In the same corresponding periods, STMB experienced not only highly volatile changes but the changes were also happening at very low rates, far off from that achieved by TNSB. Except in 2001, when the annuity scheme was available, STMB's rates barely breached the 40 per cent level. Even in 1998, when the Asian economic crisis was at its peak, TNSB managed to grow its assets by more than 50 per cent as compared to only 4.12 per cent for STMB.

The trend percentages also show the tremendous growth that TNSB was experiencing with regard to total assets, while the trend percentages of STMB indicated that it was experiencing a slower growth.

Beginning in 1999 and in terms of the absolute amount, TNSB incurred larger operating expenses than STMB. In terms of percentages, it goes back to 1995. An essential fact emerged from this comparison. Although the operating expenses of TNSB were higher, they were surpassed by the growth, especially in yearly family contributions. This signifies that TNSB was in fact very effective in managing its cost. A high proportion of TNSB's operating expenses consist of commissions paid to the agents who brought in the contributions. The commissions are paid out of a small portion of the contributions and this resulted in the linear relationship between expenses and contributions. Remember that its adoption of a particular juristic view allows some of the expenses to be charged to the contributions. This was unlike STMB. The growth in yearly family contributions was low and it did not match the growth of its operating expenses. In other words, STMB was not cost effective and not only that, it has to bear all of the expenses in its profit and loss accounts. The ratio of family contributions to operating expenses below shows the contribution for every RM1 of operating expenses for the period under review and they slightly favour TNSB.

However, the opposite occurs when the general *takaful* contributions were considered. Table 1.4c below shows that the ratio of general contributions to operating expenses support the walk-in concept more than the agency system. An explanation for this could be due to the nature of general *takaful*. As general coverage is deemed a necessity to protect against losses due to

[18] TNSB's accounting year-end is at 31st March while STMB's is at 30th June.

Table 1.4b – FAMILY CONTRIBUTIONS TO OPERATING EXPENSES

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Family Contributions (RM)	572,100,252	734,785,944	172,458,980	117,601,634	82,909,039	55,407,197	38,709,790	9,623,488	0
Operating Expenses (RM)	77,783,630	57,922,206	39,476,793	26,331,888	18,557,866	13,402,516	7,591,043	2,467,647	42,875
Contributions to Operating Expenses	7	13	4	4	4	4	5	4	0

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Family Contributions (RM)	278,686,291	563,572,408	143,035,458	116,085,572	99,684,112	65,835,023	48,603,360	26,811,934	15,557,778
Operating Expenses (RM)	57,387,958.00	47,660,771.00	34,410,313.00	24,964,199.00	21,436,479.00	16,382,658.00	13,003,710.00	9,627,344.00	6,901,777.00
Contributions to Operating Expenses	4.86	11.82	4.16	4.65	4.65	4.02	3.74	2.78	2.25

Table 1.4c – GENERAL CONTRIBUTIONS TO OPERATING EXPENSES

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
General Contributions (RM)	80,370,387	68,792,930	36,465,630	20,053,156	15,046,560	5,861,480	4,032,126	2,149,707	0
Operating Expenses (RM)	77,783,630	57,922,206	39,476,793	26,331,888	18,557,866	13,402,516	7,591,043	2,467,647	42,875
Contributions to Operating Expenses	1	1	1	1	1	0	1	1	0

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
General Contributions (RM)	196,416,677	150,005,039	113,136,975	107,602,150	99,073,101	79,520,690	63,379,848	56,701,050	39,084,889
Operating Expenses (RM)	57,387,958.00	47,660,771.00	34,410,313.00	24,964,199.00	21,436,479.00	16,382,658.00	13,003,710.00	9,627,344.00	6,901,777.00
Contributions to Operating Expenses	3.42	3.15	3.29	4.31	4.62	4.85	4.87	5.89	5.66

accident, fire or theft, customers do not need that much persuasion to buy the plans. Furthermore, they would be in the know of when the due date of the plans would expire, making them take that extra effort to buy from the nearest branches. Hence, a walk-in concept could still prevail over an agency system, as far as the general *takaful* is concerned.

The impact of the observations from the analysis on contributions and operating expenses will be on the company's profits before *zakat* and tax. For STMB, as a result of lower contributions collected due to non-agents, lesser amounts would be available for investments and thus the returns in the form of shared profits will be lower. Secondly, since it has to continuously open up new branches, a large portion of the contributions would be utilised for and tied up in fixed assets, making the amount available for investments to be even lower.

Thirdly, by not being able to share the expenses with the participants by charging some of the expenses to the contributions, it has put additional burden on the company, and subsequently on its profit before *zakat* and tax.

From the table above, during the economic crisis in 1998, STMB suffered a loss of about RM 7 million while TNSB made a profit. In fact, from that year onwards, with the exception of 1999, TNSB was more profitable than STMB. Its profits before *zakat* and tax nearly doubled that of STMB in the last two years of the analysis. In most of the years under the period of study, the changes from previous years in absolute amount and in percentage showed that STMB's profits demonstrated high fluctuations. In contrast TNSB's profits were more stable, as the biggest decrease in terms of the amount was only about RM 3 million.

The trend percentages proved that TNSB was again outperforming STMB. In just a short number of years, the quantum of changes in the profit before *zakat* and tax of TNSB breached the 9000 points, indicating a high growth in the company's performance.

5.4. Results of ratio analysis

The analysis will apply the group of ratios used in the conventional insurance industry, with appropriate modification to the terms used, for the purpose of suitability for the *takaful* industry. The reason for this is that there are no reports or studies before that had tried to compare the performance of *takaful* companies. Dynaquest, a research and consultancy firm based in Kuala Lumpur, developed the group of ratios used for the conventional insurance industry. Their report on the results of the ratios was acquired by the Kuala Lumpur Stock Exchange (KLSE) and made available to the public. The two groups of ratios used were the profitability and financial (solvency) ratios, which were divided into the following ratios.

Table 1.5 – PROFIT BEFORE *ZAKAT* AND TAX (PBZT)

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Profit before *Zakat* and Tax (RM)	29,382,829	13,888,617	16,758,301	12,865,717	4,518,602	6,310,156	5,905,755	-766,093	321,275
Horizontal Analysis:									
Changes in absolute amount (RM)	15,494,212	-2,869,684	3,892,584	8,347,115	-1,791,554	404,401	6,671,848	-1,087,368	na
Changes in percentage (per cent)	111.56	-17.12	30.26	184.73	-28.39	6.85	-870.89	-338.45	na
Trend Percentages (per cent)	9145.69	4322.97	5216.19	4004.58	1406.46	1964.10	1838.22	-238.45	100

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Profit before *Zakat* and Tax (RM)	14,103,430	6,735,334	13,619,265	24,215,010	-7,057,348	18,421,705	12,031,980	9,384,602	7,752,557
Horizontal Analysis:									
Changes in absolute amount (RM)	7,368,096	-6,883,931	-10,595,745	31,272,358	-25,479,053	6,389,725	2,647,378	1,632,045	na
Changes in percentage (per cent)	109.39	-50.55	-43.76	-443.12	-138.31	53.11	28.21	21.05	na
Trend Percentages (per cent)	181.92	86.88	175.67	312.35	-91.03	237.62	155.20	121.05	100

The profitability group of ratios is made up of:

1. Premium Income to Total Assets, which is modified to Contributions to Total Assets;
2. Total Income to Total Assets; which is modified to Investment Income to Total Assets[19];
3. Profit Before Tax to Total Assets, which is modified to Profit Before *Zakat* and Tax to Total Assets and
4. Returns on Equity.

The financial (solvency) group of ratios includes:

1. Investment Assets to Total Assets;
2. Liquid Current Assets to Total Assets;
3. Fixed Assets to Total Assets;
4. Insurance funds to Total Assets, which is modified to *Takaful* funds to Total Assets and
5. Shareholders Funds (Equity) to Total Assets.

The findings of the ratio analysis of the two companies follow.

This ratio indicates what contribution was collected for every one *ringgit* of assets. The contribution figure consists of both the *takaful* business' contributions, namely the family and general *takaful*. The total assets of the companies were made up of current assets such as cash and bank balances, deposits with financial institutions and debtors, investment assets with money bearing securities and fixed assets. Contribution is the *raison d'être* of the *takaful* business, as apart from providing coverage to the participants, it is also the source of revenue for the company through the returns made from investing it.

From the table, TNSB was more profitable than STMB, using this particular profitability ratio. It has consistently outperformed STMB, with the exception of 1995 and 1998. As such, TNSB generated higher contribution per *ringgit* assets, indicating it has utilised its assets better. The comparison made between the companies' total assets earlier indicated that prior to 2002, TNSB had a smaller assets base than STMB. It goes to show that agents' penetration is higher as compared to the concept of walk-in customers.

Apart from the early years of TNSB, there was only one other occasion when STMB performed slightly better. That was in 2001 when its ratio of 0.03 bettered TNSBs' by 1 per cent. As previously stated, apart from 2002, TNSB's total assets were always smaller than STMBs'. However, these did not prevent it from doing better than its main rival. Investment income is the main in-

[19] The total income for a conventional insurance company is the premium collected plus the income form investment. In *takaful* this is not possible because the premium (contribution) collected does not belong to the companies.

come of any *takaful* company and it depends very much on the contributions collected, apart from the investment skills of managers. TNSB experienced a higher annual increase of contributions and as it does not have to be concerned with fixed expenditures and operating expenses, TNSB was able to invest much of the contributions collected.

This ratio indicates how much profit before *zakat* and tax was generated per one *ringgit* of assets. Beginning in 1996, TNSB had either been more profitable or at least matched the performance of STMB. STMB had even suffered a negative ratio of –0.02 due to losses it incurred in 1998. TNSB had utilised its smaller assets base efficiently to achieve a similar ratio performance. This is yet another indicator of the positive results that the agency system can bring.

This ratio is calculated by dividing the shareholders funds with profit after *zakat* and tax. Since 1996, TNSB's ROE had bettered the ROE of STMB. Again, this was achieved in a short period of time since its inception. Unless and until STMB changes its policy, its situation as depicted above will continue or even worsen. Without agents, it has to continue with its annual high fixed assets investments or high expenses in the case of renting. It then also has to continue informing participants of its products and services, resulting in higher expenses due to advertisements and promotions. Furthermore, since STMB is unable to split its operating expenses, the smaller revenues are mismatched with the higher operating expenses. All of these would deflate profits.

This is the first ratio under the group of financial solvency ratios. It is interesting to note that since its inception, a very large portion (more than 90 per cent) of TNSB total assets was made up of its investment assets. The contributions collected provided the amount available for investments and with that the main purpose of TNSB, where contribution was concerned, was to invest them in money bearing securities.

Whereas TNSB investment assets had been large, STMB's was on the decline, except for 2001 and 2002 when helped by the annuity scheme, the investment assets made up 86 per cent and 85 per cent of its total assets. In 1994 for instance, investment assets only represented 60 per cent of total assets, while in 1998 it was only 65 per cent. If investment assets constituted only a small percentage of total assets, it will ultimately result in smaller returns on investment. Thus, STMB suffers not only from lower contribution collected, as shown in the analysis of the profitability ratios earlier, but also from the smaller amount that is available for shorter term investments.

The following analysis would show that a big portion of the STMB's contributions is used to part financed the purchase of its fixed assets.

The above two tables give the breakdown of the composition of the assets other than investment assets. The liquid current assets of both companies were considered sufficient to cover their respective current liabilities.

Table 1.6 – CONTRIBUTIONS TO TOTAL ASSETS

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Total Contribution(RM)	652,470,639	803,578,874	208,924,610	137,654,790	97,955,599	61,268,677	42,741,916	11,773,195	0
Total Assets(RM)	1,856,421,480	1,247,624,459	573,540,058	371,258,863	233,754,564	151,745,509	82,869,669	37,686,753	20,727,789
Contribution to Total Assets	0.35	0.64	0.36	0.37	0.42	0.40	0.52	0.31	0.00

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Total Contribution(RM)	475,102,968	713,577,447	256,172,433	223,687,722	198,757,213	145,355,713	111,983,208	83,512,984	54,642,667
Total Assets(RM)	1,572,180,707	1,302,590,765	726,596,152	589,231,270	437,594,201	420,296,808	298,656,438	202,004,299	150,437,077
Contribution to Total Assets	0.30	0.55	0.35	0.38	0.45	0.35	0.37	0.41	0.36

Table 1.7 – INVESTMENT INCOMES TO TOTAL ASSETS

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Investment Income(RM)	76,043,479	30,274,206	34,963,930	26,494,986	5,858,145	12,328,502	8,085,499	211,981	385,482
Total Assets(RM)	1,856,421,480	1,247,624,459	573,540,058	371,258,863	233,754,564	151,745,509	82,869,669	37,686,753	20,727,789
Investment income to Total Assets	0.04	0.02	0.06	0.07	0.03	0.08	0.10	0.01	0.02

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Investment Income (RM)	54,929,963	32,928,608	21,872,592	33,831,363	4,084,049	26,649,513	17,211,765	12,733,781	12,310,919
Total Assets (RM)	1,572,180,707	1,302,590,765	726,596,152	589,231,270	437,594,201	420,296,808	298,656,438	202,004,299	150,437,077
Investment income to Total Assets	0.03	0.03	0.03	0.06	0.01	0.06	0.06	0.06	0.08

Table 1.8 – PROFIT BEFORE *ZAKAT* AND TAX TO TOTAL ASSETS

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
PBZT (RM)	29,382,829.00	13,888,617.00	16,758,301	12,865,717	4,518,602	6,310,156	5,905,755	-766,093	321,275
Total Assets (RM)	1,856,421,480	1,247,624,459	573,540,058	371,258,863	233,754,564	151,745,509	82,869,669	37,686,753	20,727,789
PBZT to	0.02	0.01	0.03	0.03	0.02	0.04	0.07	-0.02	0.02
Total Assets									

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
PBZT(RM)	14,103,430	6,735,334	13,619,265	24,215,010	-7,057,348	18,421,705	12,031,980	9,384,602	7,752,557
Total Assets (RM)	1,572,180,707	1,302,590,765	726,596,152	589,231,270	437,594,201	420,296,808	298,656,438	202,004,299	150,437,077
PBZT to	0.01	0.01	0.02	0.04	-0.02	0.04	0.04	0.05	0.05
Total Assets									

Table 1.9 – RETURNS ON EQUITY (ROE)

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
PBZT(RM)	29,382,829	13,888,617	16,758,301	12,865,717	4,518,602	6,310,156	5,905,755	-766,093	321,275
Shareholders funds(RM)	73,253,753	55,497,802	49,762,206	41,856,710	30,754,287	28,854,091	25,766,935	23,507,073	20,265,275
Returns on Equity	0.40	0.25	0.34	0.31	0.15	0.22	0.23	-0.03	0.02

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
PBZT(RM)	14,103,430	6,735,334	13,619,265	24,215,010	-7,057,348	18,421,705	12,031,980	9,384,602	7,752,557
Shareholders funds(RM)	111,001,381	99,013,065	98,286,786.00	92,629,082.00	77,108,602.00	86,459,743.00	54,351,043.00	25,871,215.00	22,006,017.00
Returns on Equity	0.13	0.07	0.14	0.26	-0.09	0.21	0.22	0.36	0.35

Table 1.10 – INVESTMENT ASSETS TO TOTAL ASSETS

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Investment Assets(RM)	1,803,630,065	1,177,107,242	538,739,449	350,225,966	225,427,424	145,006,464	77,859,913	36,983,901	20,529,093
Total Assets(RM)	1,856,421,480	1,247,624,459	573,540,058	371,258,863	233,754,564	151,745,509	82,869,669	37,686,753	20,727,789
Investment Assets to Total Assets	0.97	0.94	0.94	0.94	0.96	0.96	0.94	0.98	0.99

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Investment Assets(RM)	1,338,179,035	1,113,996,593	587,555,577	463,433,947	286,489,960	294,503,149	244,521,640	182,210,078	90,532,091
Total Assets(RM)	1,572,180,707	1,302,590,765	726,596,152	589,231,270	437,594,201	420,296,808	298,656,438	202,004,299	150,437,077
Investment Assets to Total Assets	0.85	0.86	0.81	0.79	0.65	0.70	0.82	0.90	0.60

Table 1.11 – LIQUID CURRENT ASSETS TO TOTAL ASSETS

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Liquid Current assets(RM)	45,851,916	63,525,509	29,370,396	16,181,492	4,739,212	4,939,180	3,392,049	529,282	110,074
Total Assets(RM)	1,856,421,480	1,247,624,459	573,540,058	371,258,863	233,754,564	151,745,509	82,869,669	37,686,753	20,727,789
Liquid Current Assets to Total Assets	0.02	0.05	0.05	0.04	0.02	0.03	0.04	0.01	0.01

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Liquid Current assets(RM)	92,926,244	51,797,261	19,096,110	13,391,434	42,438,109	94,411,674	38,470,873	16,021,151	56,143,727
Total Assets(RM)	1,572,180,707	1,302,590,765	726,596,152	589,231,270	437,594,201	420,296,808	298,656,438	202,004,299	150,437,077
Liquid Current Assets to Total Assets	0.06	0.04	0.03	0.02	0.10	0.22	0.13	0.08	0.37

Table 1.12 – FIXED ASSETS TO TOTAL ASSETS

TNSB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Fixed Assets(RM)	6,939,499	6,991,708	5,430,213	4,851,403	3,587,928	1,799,865	1,617,707	173,570	88,622
Total Assets(RM)	1,856,421,480	1,247,624,459	573,540,058	371,258,863	233,754,564	151,745,509	82,869,669	37,686,753	20,727,789
Fixed Assets to	0.004	0.006	0.009	0.013	0.015	0.012	0.020	0.005	0.004
Total Assets									

STMB	2002	2001	2000	1999	1998	1997	1996	1995	1994
Fixed Assets(RM)	141,075,428	136,796,911	128,024,119	119,558,086	108,722,304	31,381,985	15,663,925	3,773,070	3,761,259
Total Assets(RM)	1,572,180,707	1,302,590,765	726,596,152	589,231,270	437,594,201	420,296,808	298,656,438	202,004,299	150,437,077
Fixed Assets to	0.09	0.11	0.18	0.20	0.25	0.07	0.05	0.02	0.03
Total Assets									

Table 1.12b – *TAKAFUL* AND SHAREHOLDERS FUNDS TO TOTAL ASSETS

STMB	2000	1999	1998	1997
From *takaful* funds (RM)	83,105,613	76,792,507	70,092,835	16,932,483
From Shareholders funds (RM)	44,918,506	42,765,579	38,629,469	14,449,502
Fixed Assets (RM)	128,024,119	119,558,086	108,722,304	31,381,985
Takaful funds to Fixed Assets	0.65	0.64	0.64	0.54
Shareholders funds to Fixed Assets	0.35	0.36	0.36	0.46

Table 1.12c – CHANGES IN *TAKAFUL* AND SHAREHOLDERS FUNDS TO CHANGES IN FIXED ASSETS

STMB	2000	1999	1998
Changes in *takaful* funds financing Fixed Assets (RM)	6,313,106.00	6,699,672.00	53,160,352.00
Changes in shareholders funds financing Fixed Assets (RM)	2,152,927.00	4,136,110.00	24,179,967.00
Changes in Fixed Assets (RM)	8,466,033.00	10,835,782.00	77,340,319.00
Changes in *takaful* funds to changes in Fixed Assets	0.75	0.62	0.69
Changes in shareholders funds to changes in fixed Assets	0.25	0.38	0.31

Fixed assets constituted a large percentage of all assets as far as STMB is concerned. From 1998 to 2001, the ratios stood at more than 10 per cent. The lowest that STMB recorded was in 1995 when its fixed assets formed 2 per cent of total assets. TNSB's fixed assets to total assets were dwarfed in comparison to STMBs', where for all the years under investigation, its ratios barely exceeded 1 per cent.

Table 1.12b shows how STMB financed its yearly total fixed assets. For example, in the year 2000, total fixed assets amounted to RM128, 024,119. Out of this amount, approximately RM83 million or 65 per cent were financed using the *takaful* funds, in other words from the accumulated contributions collected from the participants. Only RM44 million or 35 per cent came from the shareholders funds. Similar percentages were derived in 1998 and 1999.

Table 1.12c extends the analysis from the preceding table. In 2000, additions to the fixed assets, after depreciation, came to over RM8 million. Out of this, over RM6 million (75 per cent) was used from the *takaful* funds, while only RM 2.1 million or 25 per cent from the shareholders funds.

From these observations, STMB needed a substantial amount from contributions collected to part finance its continuous expansion through the opening up of branches and *takaful* counters. Fixed asset investments would also yield some returns in terms of gains due to appreciation of values and from rental income. However, the gains are not as immediate as shorter-term investments, and it would require something extraordinary for STMB to vacate its servicing branches. As for rental, the majority of the income is made up of inter company transactions, instead of rental received from outsiders. The Chairman's Statement of STMB's annual reports specifically stated that the main sources of STMB's income are the returns of investment of shareholders' funds and the share of profits of both *takaful* businesses, and not from returns from fixed assets.

Hence, a large portion of contributions (e.g. year 2000 – RM83 million) is tied up in fixed assets. This is unlike TNSB, where its main objective of the contributions collected is to put them in money bearing securities and investments. To show the degree of spending of fixed assets of both companies, the balance sheet for 2000 and 1999 will be taken as an example. The annual reports of STMB indicate that its fixed assets were valued at RM128, 024,119 and RM119, 558,086 respectively. Its cash outflow from investing activities in the purchase of fixed assets for the 2 years were RM11, 974,260 and RM13, 506,662 respectively. In contrast, the balance sheet figures of TNSB for its fixed assets for the 2 years were RM5, 430,253 for 2000 and RM4, 851,403 for 1999. Its cash outflow from investing activities in the purchase of fixed assets were only RM2, 392,888 for 2000 and RM2, 725,258 for 1999. These TNSB's assets include the purchase of a limited number of office space to cater for the purpose of administering the agency systems, throughout the country.

All of these continuous acquisitions of fixed assets would not be necessary for STMB if agents were used instead. More contributions will be freed to be channelled into shorter-term investments and consequently raise the performance of the company.

6. Conclusions

Both companies offered very similar products with very similar benefits, and operating in the same market, in fact targeting the same market segment of the majority Malaysian Muslims. This leads to them having to compete in the same environment, facing the same political, economical, legal and social-cultural forces. Both companies have very similar organisational structures and operate in accordance to the rules and regulations of Islamic law derived from the pretext of *Sharia*h. Each company's Shariah Supervisory Council ensures that the activities of the companies comply with the *Shariah* requirements, activities that include investments in *halal* or permissible securities. Hence, the investment portfolios of both companies will mirror one another and include among others, investments in the green counters listed in KLSE, Islamic bonds market and Government Islamic Investments (GII).

Yet, even with so many similarities between them, when it comes to performance and consequently profitability of the companies, they differ considerably. Results from the analysis have shown that overall, TNSB had outperformed or at least matched STMB in almost all areas that were subject to comparison by demonstrating higher profitability and better financial solvency.

The better performance of TNSB could be attributed to its ability to leverage its internal strengths in order to be more competitively advantageous. Since the external opportunities and threats facing both companies are the same, it is obvious that differences in internal operations could be the main reason. Again, internally, the structure of the organisations for both companies does not remarkably differ. What could be the difference that led to such diversity in performances? The answer lies in the strategy of procuring and soliciting contributions from participants – the strategy of utilising agents against the strategy of opening up branches in order to reach the participants.

The results of the studies have shown that STMB should consider their policy of not employing agents. There are no barriers to its implementation, either from the *Shariah*, or from other perspectives. It should consider stopping the opening up of new branches and instead use the current branches to facilitate the agency system. STMB has more offices than TNSB and a direct changeover to the agency system would not only be possible, but would provide them with an immediate advantage.

Perhaps it could also consider another alternative to the usage of the current offices to just merely facilitating the agency system after the changeover. It could look into the strategy of separating the two *takaful* business' marketing

channel. For the family *takaful* business, it must utilise agents, for agents have been proven by the study to be the important factor in influencing customers' purchase decisions. As for the general *takaful* business, it can use the current branches to partly cater for the business, or to own higher business volumes than agents. In general, hazard *takaful* plans such as motor, fire etc. are necessary coverage and usually do not need a higher level of influence from agents in order for customers to purchase. This remark is supported by the analyses on general *takaful* from the above. This is where the concept of walk-in customers would be better off and the agents could be used to promote the general *takaful* plans during their meetings with customers. These strategies should be evaluated and consequently implemented if STMB wishes to continue to be a major player in the *takaful* industry. With the advent of globalisation leading to increased competition domestically and internationally, STMB has to do this expeditiously.

STMB should not equate the principle of *mudharabah* with total prohibition of the agency system. Interestingly enough, even if it decides to continue with *mudharabah* and at the same time implement the system, it can still avoid going against the definition given in the encyclopaedia. The reason for this is because the issue of non-permissibility will only arise if the payment to the agents, which is perceived as management costs, is taken from the capital or deducted from the gross profit. Should the payment be taken from the share of profit of the *mudharib*, i.e. the company's share after paying the share attributable to participants, the issue will no longer be relevant. If there is no profit made, the expenses can be covered by the company by utilising the shareholders' fund. This reasoning means that management expenses will always be borne by the company which is in fact consistent with the last line given in the definition. However, profits will be further depressed if STMB bears all expenses. For this reason, it is imperative that it should adopt the interpretation of other schools of thoughts so that it can charge the agents' commissions and part of the management expenses related to *takaful* funds to the *takaful* funds.

Adoption of views from other school of laws will not be inconsistent with STMB's plan or that of its related company, BIMB, as they have adopted the views of other schools besides *Shafi'is* in other spheres concerning their operations. Examples of these are given below:

1. *Takaful* is permissible in Islam, because it is based on the contract of *tabarru'*. Consequently, as this contract is unilateral in nature, the element of *gharar* is tolerable from the Islamic perspective. This view of *gharar* being tolerable in unilateral contracts is that of the *Maliki* school of law and not the *Shafi'is*. The *Shafi'is* are of the opinion that *gharar* is not tolerable under any contractual circumstances and unilateral contracts must be free of it. Hence, STMB would not have been able to implement the *takaful* business if it had followed the *Shafi'is* view.

2. BIMB is operating a parallel or two-tier *mudharabah* in its *mudharabah* transactions. A two-tier *mudharabah* involves three parties that include the capital providers (i.e. the depositors in *mudharabah* savings account), the intermediate *mudharib* (i.e. BIMB) and the final *mudharib* (the entrepreneur in *mudharabah* financing). This parallel *mudharabah* or *mudharib yudarib* is only acceptable according to the *Hanafis* in contrast to the majority of the scholars.

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HABIB AHMED

Frontiers of Islamic Banks: A Synthesis of the Social Role and Microfinance*

Abstract

Financing small and medium enterprises is viewed as a new paradigm to alleviate poverty and bring about development. Specialised poverty-focused microfinance institutions have evolved over the last 25 years to finance microentrepreneurs. Problems facing these institutions are, amongst others, non-viability and dependence on subsidised funds for operations. Recently, a few Islamic microfinance institutions have also started up operations in some countries. Operations of these institutions, however, have limited impact due to a lack of funds and trained employees. Unlike conventional banks, Islamic banks' objectives should include social dimensions. Given this social role, Islamic banks can complement the efforts of Islamic microfinance institutions in providing the much-needed funds to the poor to facilitate their economic uplifting. The paper asserts that Islamic banks are predisposed to provide microfinance in a *win-win* situation. In other words, Islamic banks can finance the poor at no extra cost. Theoretical arguments presented show that Islamic banks can provide microfinance more efficiently benefiting from its scale of operations. To support some of the theoretical assertions, empirical evidence is given from the experience of the Rural Development Scheme, a microfinance program of the Islami Bank Bangladesh Limited. The experience of the Islamic Development Bank in financing microenterprises is also outlined.

1. Introduction

The last quarter of the 20th century witnessed numerous financial innovations that catered to various needs of different segments of society. While most of these innovations were concentrated in countries with developed financial markets, a couple of new ideas emerged from Muslim countries. The concepts of 'Islamic banking' and 'microfinance' surfaced almost concurrently, yet independently, in the mid-1970s. From its humble start, Islamic financial institutions have grown rapidly in size and scope. Given the large size of the potential market, non-Islamic financial institutions are also offering financial

* I would like to thank Shah Abdul Hannan, Muzahidul Islam, M. Kamaluddin Chowdhury, M. Tajul Islam, and Md. Obaidul Haque for their assistance and support in gathering information on microfinance institutions in Bangladesh and the Rural Development Scheme of the Islami Bank Bangladesh Ltd. A version of this paper was presented at the *Forum on Islamic Economics and Finance* held in Amman Jordan held from September 27-29, 2003 and organised by The Arab Academy for Banking and Financial Sciences. The views and opinion expressed in this paper are personal to the author and do not represent those of the Islamic Research and Training Institute or of the Islamic Development Bank.

services that conform to Islamic principles. Currently, it is presumed to be one the fastest growing sectors in the banking industry worldwide. Similarly, microfinance institutions (MFIs), pioneered by Professor Muhammed Yunus of Grameen Bank in Bangladesh, have burgeoned in both developing and industrialised countries. After the failure of a few decades of top-down (trickle down) development policies to alleviate poverty in most developing countries, the innovative microfinance initiative is considered a new paradigm for bringing about development and eradicating absolute poverty.[1] *Microcredit Summit 1997* envisaged that 100 million poor would have access to microfinance by 2005. Multilateral financial institutions and international donors have adopted microfinance as a powerful tool for poverty alleviation and economic development.

Due to a lack of collateral and to asymmetric information problems, poor microentrepreneurs cannot obtain finance from conventional institutional sources. Before the advent of MFIs, most microenterprises were financed by non-institutional sources that charged exorbitant interest rates. In recent times, however, specialised poverty-focused MFIs are providing the much-needed finance to a small section of microentrepreneurs resulting in the increase in their income and wealth. The MFIs innovative group-based format introduces social collateral minimising the asymmetric information problems and ensuring higher recovery rates. Most MFIs, however, are non-Islamic in character. Other than charging interest, the social agenda that is associated with these programs has secular features. A few MFIs with Islamic orientation have recently begun operations in some countries. Their operations, however, are miniscule compared to the large number of poor population that needs to be served.

Most of the Islamic banks, as with their conventional counterparts, have not ventured into mircofinancing. Whereas it is understandable why conventional banks are not involved in microfinancing, it is not befitting for Islamic banks to do the same. Islamic financial institutions have fundamentally different objectives compared to their conventional counterparts. Khan (1997) discusses this issue. He points out that if the only difference between Islamic and conventional banking practices is whether the business is interest-based or not, then the non-Islamic financial institutions probably can deliver Islamic services better than Islamic banks. He asserts that a distinct aspect of an Islamic enterprise is the social dimension in its operations.

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[1] Growth in microenterprises or small enterprises can be an important means of employment generation and development of poor countries. A high population growth rate and limited employment opportunities in the agricultural and the modern manufacturing sectors, leaves a vast majority of the labour force without productive employment. Microenterprises can play an important role in employing the surplus labour force productively (World Bank, 1978). For an extensive study on microfinance, see, for example, Hulme and Mosley, (1996), *Journal of International Development* (Vol. 8, No. 2), Kimenyi, Weiland, and Pischke (1997), Otero and Rhyne (1994), and Schneider (1997).

One way of manifesting the social role of Islamic banks is to provide finance to the poor to increase their income and wealth. The innovative operational format used by the MFIs suits the poor and can be employed by the Islamic banks to provide such finance. This paper investigates if a marriage between Islamic banks and microfinancing is possible. The paper argues that there is a strong case for such a union as Islamic banks can deliver finance to the poor more efficiently and effectively. The theoretical arguments are supported by empirical evidence of the Rural Development Scheme, a microfinance Program of the Islami Bank Bangladesh Limited.

The paper is organised as follows. Section 2 discusses the need for social intermediation to finance microenterprises. The section then outlines the characteristics and operations of MFIs and points out some of the problems faced by them. In section 3, the scope and constraints of Islamic MFIs are discussed. Section 4 outlines the theoretical arguments for Islamic banks' involvement in microfinancing, followed by a section of comparative analysis of Islamic banks and MFIs in financing microenterprises. In section 6, the microfinance experience of the Islami Bank Bangladesh Limited is discussed in light of the theoretical assertions made. Section 7 concludes the paper.

2. Financing microenterprises: the need for social intermediation

Smaller firms do not have access to funds from traditional financial institutions. The underlying theoretical explanation for this phenomenon lies in the traditional problems of asymmetric information in financial intermediation. Bennett (1998) points out some barriers that accentuate the asymmetric information problems in case of smaller enterprises in developing countries. Physical barriers of poor infrastructure such as lack of markets, roads, power, communications, etc., can worsen both the adverse selection and moral hazard problems. Physical constraints inhibit the financial institutions to gather information on their prospective clients and once credit is advanced, it is difficult to monitor the use of the funds. Socioeconomic factors of clients such as low numerical skills due to illiteracy, caste/ethnicity/gender aspects preventing interaction, also add to the adverse selection problem. The microentrepreneur's lack of collateral, due to poverty, can increase the moral hazard problem. These barriers would make the assessment of projects and the monitoring of the use of loans, very costly. Furthermore, as the size of the loan for microenterprise is small, the administering cost of per-unit loans increases. These economic factors make it impossible for traditional financial institutions to offer credit to microenterprises.

Given the above problems in financing microenterprises and also the fact that these small-scale enterprises are an important means to increase employment and reduce poverty, there is a need for a social financial intermediation

of funds for microentrepreneurs. Bennett (1998) points out two approaches of financing microenterprises. First, the linking approach, under which conventional financial institutions are linked to the target group, (i.e., the poor) through some intermediary. The other approach is to provide microcredit through specialised organisations, such as NGOs, government agencies, cooperatives, and development finance institutions. Almost all financing for microenterprises in recent times has come from the latter institutions, which cater to the needs of the poor. This focus of this paper, however, is on the former linking approach. We argue that Islamic banks can finance microenterprises more efficiently than MFIs. Before examining how this is done, the operations, prospects, and problems of conventional and Islamic MFIs are discussed.

2.1. MFIs: specialised financial institutions

Though the importance of financing small-scale enterprises has been felt for a long time, the concept of group-based poverty focused microfinance is a relatively new concept with distinct characteristics.[2] Pioneered by the Grameen Bank in Bangladesh, group-based MFIs are banks for the poor and operate quite differently from the conventional commercial banks. Whereas commercial banks are profit maximising firms, MFIs are either government or non-government organisations (NGOs) formed to provide the poor with their much-needed finance. Given this nature, most MFIs have a social development program together with credit facilities.

To receive finance from these institutions, the client or beneficiary must be poor.[3] A person must form a group of five like-minded people with a similar socioeconomic status in order to receive credit. Male and female groups are formed separately and relatives cannot be in the same group. A group is usually trained for a couple of weeks to become familiar with the rules and procedures of the MFI. A number of groups are federated into a centre with a centre chief and deputy centre chief elected from the group. Weekly meetings of the centre are held at a convenient place in the locality. All members (i.e., beneficiaries) of the centre are required to attend these meetings. An MFI official attends these weekly meetings to conduct banking transactions and other business of the centre.

MFIs extend credit of small amounts at a reasonable rate of interest. The loan is paid back in one year in (fifty) weekly instalments. Credit is provided to the poor without any physical collateral. Instead, social collateral is introduced

[2] Though different approaches to microfinance have evolved, the format discussed here is that of Grameen Bank, which serves as the dominant model for most group-based microfinance institutions (Morduch, 1999).

[3] Different MFIs define their target groups in different ways. For example, to be eligible to receive credit from the Grameen Bank, a household must own less than 0.4 acres of land and must not have assets exceeding the market value of one acre of cultivable land.

by forming groups. Loan repayment by an individual member of a group is the collective responsibility of all the members in the group and default by a member disqualifies all members to receive any new loans. As a result, members in the group monitor each other's activities and peer pressure induces the repayment of the loan. This form of peer monitoring mitigates the problem of asymmetric information and reduces transaction costs (Huppi and Feder, 1990; Morduch, 1999; Stiglitz 1990). Most MFIs have various (forced) savings programs. Sometimes, MFIs also extend credit to individuals for building houses and to a group or centre for a collective enterprise.

Most MFIs have a social development program associated with financing. The objective of this program is to generate personal and social consciousness amongst the members. These programs include aspects that affect behavioural changes (such as personal hygiene, sanitation, drinking clean water, etc.), moral teachings (such as teaching honesty, discipline, and cooperation with each other), and social customs (e.g. accepting family planning, not practising the dowry system, etc.). Knowing these principles and norms are prerequisites to obtain loans from the MFI and are continuously instilled in the members during the weekly meetings. At times, necessary inputs to implement these social programs (such as tube wells for water, oral re-hydration salt, etc.) are provided by the MFI on a subsidised basis.

2.2. MFIs: Problems and constraints

Whilst a large amount of literature exists that shows the success of MFIs, some recent studies show the failure of these institutions in reaching some of their objectives.[4] The problems relevant to this paper are given below.

a) *Asymmetric information problems:* The bulk of the loan by microfinance institutions is targeted towards women. In reality, however, the male members of the household initiate the taking out of loans and control the funds received by the female members. Furthermore, loans taken from the bank are often used for purposes other than those the loan is sanctioned for (Rahman, 1999: 75). When loans are used for non-productive purposes, the chances of default increase. Buckley (1996: 390) reports that in 1993, 46 per cent of the Malawi Mudzi Fund's (a MFI in Malawi) borrowers were in arrears (did not pay instalments from once to four times) because they diverted the funds for consumption purposes. Among the defaulters (those who did not pay more than 4 instalments), the corresponding number was 33 per cent.

b) *Economic viability of microfinance institutions:* Ideally, microfinancing would be a win-win situation, where the MFI operates at a profit and the poor benefit from the credit program. This, however, is not the case for most

[4] For accomplishments of MFIs see Bornstein (1996), Fuglesang and Chandler (1993), Goetz and Gupta (1996), Hashemi, *et.al.* (1996), and Hossain (1983 and 1987).

MFIs (Morduch, 1999). Due to a lack of fund mobilisation and the high administrative costs, most MFIs are not economically viable.[5]

c) *High drop-out rate and non-graduation from poverty:* Ditcher (1996), Hulme and Mosley (1996), and Montgomery (1996) report that microfinance institutions do not serve the poorest, who are either not given loans, or drop out of the credit schemes.[6] Karim and Osada (1998) observe that there is a steady increase in the dropout rate from the Grameen Bank (15 per cent in 1994) and that 88 per cent of the total dropouts did not graduate to the status of non-poor. Assaduzzaman (1997) finds that whereas microfinance does increase the income level of the poor, the current operations of MFIs are not very effective in improving the lives of the extreme poor.

3. Islamic MFIs: prospects and problems

Given the important role of financing microenterprises in alleviating poverty, several Islamic MFIs have been initiated in some countries. Islamic MFIs retain the innovative operational format of conventional MFIs and orient the program towards Islamic principles and values.[7] Islamic MFIs, however, can have potentially more varied liabilities and assets. For example, on the asset side, various modes of financing used and on the liability side, sources of income can also include *zakat, waqf*, etc. Furthermore, the Islamic content of the Social Development Program can build the social capital that is needed for the successful functioning of MFIs.

Islamic MFIs have some inherent characteristics that can mitigate some of the problems faced by conventional MFIs as pointed out in Section 3. By targeting the family unit instead of women members in the household, the adverse selection and moral hazard problems of the recipients not using the funds may be minimised. Furthermore, as Islamic finance involves real transaction instead of cash being given out, the opportunity of diverting funds for uses other than that requested is eliminated. The nature of the social capital intrinsic in the Islamic social development program can potentially decrease the default rate. As solidarity among the group members increases and ben-

[5] For example, Bennett (1998: 116) reports that the administrative cost of five MFIs in South Asia is in the range of 24 percent to more than 400 percent of per dollar loaned. Reed and Befus (1994: 190) study five MFIs and find the average returns on assets for three of these below 2 percent, one at 3.5 percent and the other at 14.6 percent. Hashemi (1997) and Khandker, *et.al.* (1995) point out that the Grameen Bank would operate at a loss without grants. A Subsidy Dependence Index (SDI) developed by Yaron (1997) indicates that in 1996, the Grameen Bank would have to increase its lending interest rate by an additional 21 percent in order to break even without subsidies (Hashemi, 1997). Similarly, Hulme and Mosley (1996: 52) find that 12 out of 13 MFIs from six countries have positive SDI ranging from 32 percent to 1884 percent.

[6] For example, dropout rates for the Grameen Bank and BRAC are 15 percent and 10-15 percent per annum, respectively (Hulme and Mosley, 1996: 122).

[7] For a discussion on Islamic MFIs in Bangladesh see Ahmed (2002).

eficiaries take it as a religious obligation to repay their debt. All these factors improve the profitability/viability of Islamic MFIs.

The institutions of *zakat*, *sadaqat*, and *waqf* can be integrated into a microfinancing program to effectively alleviate absolute poverty.[8] While paying *zakat* is obligatory for every wealthy Muslim, *sadaqat* are voluntary charities given to the deserving. *Zakat* and *sadaqat* in Islam are important tools for the redistribution of income and growth and are used to increase participation of the poor in production (El-Ghazali, 1994: 48). *Zakat* and income from *waqf* can be integrated into the microfinancing system to benefit the poorest beneficiaries. *Zakat* given to the poor can be used for consumption, asset building, and production purposes to complement the funds of Islamic MFIs. These complementary funds can either be given as grants or interest free loans (*qard-hasan*) according to the needs of the beneficiary. As these complementary funds will reduce the need for diverting money to consumption and purchase of assets, it is expected the funds taken for productive activities will be invested accordingly. As a result, the overall return on invested funds is expected to be higher and the probability of default, lower. Thus, integrating Islamic institutions of *zakat,* charities and *waqf* with microfinancing will not only include the core poor in the program, but also ensure the repayment of the funds to the Islamic MFI. A survey of Islamic MFIs, however, reveals that they are not employing their full usable potential (Ahmed 2002). The same survey shows that Islamic MFIs face the following problems that hinder their growth.

i) *Lack of funds*

Officials of the surveyed Islamic MFIs contend that expansion of their activities is hampered by lack of funds. MFIs cannot attract deposits as commercial banks do. Other than the initial start-up capital provided by a few volunteers, most of the funds for conventional MFIs come from external sources and beneficiary savings. The need for funds is greatest during the initial stages of operations of MFIs when the beneficiaries savings are nil or small. As the MFIs grow, the savings of beneficiaries accumulate and these can then be recycled in financing microenterprises. The time required for an MFI to operate its activities based solely on beneficiaries' savings, however, may be very long.[9] As pointed out above, Islamic MFIs have not yet tapped into the funds from the Islamic institutional sources of *zakat*, *sadaqat*, and *waqf*.

Officials of Islamic MFIs point out that there are certain problems in obtaining funds from external sources. First, the Islamic educational content of Islamic MFIs deters some external sources from funding these institutions. Second, although some funds are available from government agencies, they

[8] For detailed discussions see El Asker and Haq (1995) for *zakat* and Basar (1987) and Cizaka (1996, 1998) for *waqf*.

[9] Majority of the funds of large well-established conventional MFIs (e.g. Grameen Bank) still comes from external sources.

impose certain terms and conditions. Some of these terms and conditions are contrary to Islamic principles and limit the flexibility in the operations of Islamic MFIs. For example, the funds are given on interest and the MFIs are required to recover a certain fixed rate of return on their investments. As a result, funds from these sources cannot be employed in microfinancing using certain Islamic modes of financing (such as *mudarabah* and *musharakah*). Another implication of the lack of funds is, as the officials of Islamic MFIs indicate, that the benefits package given to employees is not as good as the established MFIs operating in the neighbourhood. This sometimes induces employees with experience to move on to other MFIs that pay better salaries and benefits.

ii) *Training*

Training employees regularly on different aspects of MFIs' operations can enhance efficiency. Training in the case of Islamic MFIs would also cover knowledge on different Islamic modes of financing and the appropriate Islamic orientation of the Social Development Program. While some training on conventional topics (such as accounting and administrative aspects) is offered from time to time by the governmental agencies, Islamic oriented training sessions are either lacking or too expensive when they are available.

The above discussion shows that while Islamic orientation in Islamic MFIs can mitigate certain problems faced by conventional MFIs (e.g. asymmetric information problems), they face a couple of constraints that limit their expansion. Given these limitations of the Islamic MFIs, we examine the prospects of Islamic banks to provide the much needed funds to the poor microentrepreneurs next.

4. Financing microenterprises by Islamic banks: rationale

The role of Islamic banks in financing microenterprises can be studied from two perspectives – first, the social dimension of Islamic institutions and second, the economic rationale for such financing. These are discussed below.

4.1 Social role of Islamic banks and microfinancing

Though there have been discussions on the nature of an Islamic enterprise in general (for example see Siddiqi, 1988), Khan (1997) focuses on the objectives of Islamic banks. He points out that the operation of Islamic banks has two aspects – the 'mechanics of it' and the 'spirit of it'. While the mechanics relate to fulfilling the Islamic legal requirements in its operations, the latter relates to faith. Any institution (including non-Islamic) can fulfil the mechanics of Islamic by providing Islamic compatible financial contracts and transactions. The spirit of an Islamic enterprise, however, distinguishes an

Islamic bank from a conventional bank. Khan (1997) points out that different variants of conventional financial institutions (such as mutual funds, Rental Equity Participation Trusts, etc.) appear to be very close to Islamic modes of financing, but this does not make these institutions Islamic. He asserts that Islamic banking has to relate its activities to faith if it has to distinguish itself from conventional financial institutions.

Khan (1997) maintains that the philosophical basis of the faith component of Islamic banks lies in adl (social justice) and ahsan (benevolence). The implication of these concepts is „taking care of those who cannot be taken care of by the market, who cannot play with economic forces or do not have access to economic means to enable them to exploit the economic opportunities around them" (Khan, 1997: 12-13). Given this characteristic, it is imperative that Islamic banks include social dimensions in their operations together with the normal banking practices.

The question is how the social role of Islamic banks can be best exemplified. Khan (1997) suggests a variety of activities such as qard-hasan, financing housing, meeting basic needs and promoting and financing small entrepreneurs. All these aspects, however, can be covered in a comprehensive integrated program with focus of microfinancing. As mentioned above, most microfinance schemes have an integrated social development program. Islamic banks, by adopting this approach of microfinancing, can engage in a much broader program of wealth creation for the poor and bring about development. As the next section reveals, they can fulfil this social role at no extra financial cost.

4.2 Islamic banks and microfinance

Other than the social dimension, there are several other arguments in favour of Islamic banks' involvement in microfinancing. Financing productive activities is the specialisation of banks. Financing microentrepreneurs will be an extension of their client base. They already have the skilled manpower that has the know-how on which to expand their microfinance operations. Islamic banks have certain other advantages over MFIs in providing such finance. By using the Islamic modes and financing and orientation, Islamic banks can mitigate the asymmetric problems faced by conventional MFIs (as discussed in Section 4). Furthermore, the lack of funds and trained personnel constraining the operations of Islamic MFIs is eliminated in Islamic banks. With its established network of branches, Islamic banks will be able to deliver services at a lower cost than MFIs. This vantage point of Islamic banks, along with the fact that the provision of microfinance can be done at no extra cost, further reinforces the argument for the involvement of Islamic banks in microfinancing. Some of the economic advantages of Islamic banks in providing finance to the poor are evident when we examine the economics of microfinancing below.

4.2.1. Economics of microfinancing

Profit (Π) of a conventional MFI is defined as the difference between its total income or revenue (TR) and total costs (TC). That is,

$$\Pi = TR - TC \tag{1}$$

Total costs of an MFI will include borrowing costs (BC) and operating costs (OC). Other than borrowing funds (F) from external sources, MFIs build up members' savings (S). If *if* and *is* are the interest rates paid on funds provided by external sources and savers respectively, then financing costs equal,

$$BC = i_f F + i_s S. \tag{2}$$

Operating costs (OC) include variable costs (wages), fixed costs O (i.e. rent, utilities, etc.). Note that these costs can be further divided as those incurred at the field level and those that are incurred away from the field (costs in head office and regional offices). For our analysis, we break down the total number of employees of the MFI, m, into those working at the field level, $m_f < m$, and those who are not working there ($m_h = m\text{-}m_f$). Thus, operating costs can be written as,

$$OC = w_f m_f + w_h m_h + O, \tag{3}$$

where w_j is the average wage rate for employee type j ($j = f, h$). Thus, total costs of an MFI equals,

$$TC = (w_f m_f + w_h m_h) + O + i_f F + i_s S. \tag{4}$$

From an accounting point of view, the income of an MFI is derived from the interest earned from loans to the beneficiaries (L) and interest earned on deposits with other financial institutions (D). The amount of loan given out by the MFI equals the average loan amount given (l) times the number of beneficiaries (n). The repayment (or recovery) rate of loans (γ) depends on, amongst other factors, the actual use of borrowed funds in the economic activity. Diversion of funds (to non-productive activities) increases the probability of default. Diversion of funds can be minimised and the repayment-rate improved with better overall supervision and monitoring of the loan. For a given number of clients, supervision and monitoring improve with more employees at the field level. In other words, as field level employees increase, the repayment rate (γ) is expected to rise. Wages paid to field level employees (w_f) can affect their incentive to work and affect recovery rates. Furthermore, higher interest rates charged for credit (i_l) increase the probability of default. The repayment rate function can be given as,

$$\gamma = \gamma(m_f/n,\ w_f,\ i_l), \qquad \gamma'_1>0,\ \gamma'_2>0,\ \gamma'_3<0; \tag{5}$$

where γ'_j (j =1,2,3) is the first derivative with respect to the jth argument. The total income of the MFI can be written as:

$$TR = \gamma(m_f/n,\ w_f,\ i_l)\ i_l\, nl + i_d\, D, \tag{6}$$

where i_l and i_d are interest rates on loans and deposits respectively. Using the definitions of costs and income from Equations (4) and (6) in Equation (1), we can write the profit of an MFI as,

$$\Pi = \gamma(m_f/n,\ w_f,\ i_l)\ i_l\, nl + i_d\, D - (w_f m_f + w_h m_h) - O - i_f F - i_s S, \tag{7}$$

Note that D, F, S, i_d, i_f, are exogenous to the system. The effects of variables that are of interest on the profit are given below;

i) $\delta\Pi/\delta i_l > 0$, *if* $\gamma\, nl > \gamma'_3\, i_l\, nl$;

ii) $\delta\Pi/\delta m_f > 0$, *if* $\gamma'_1\, i_l\, nl > w_f$;

iii) $\delta\Pi/\delta w_f > 0$, *if* $\gamma'_2\, i_l\, nl > m_f$;

iv) $\delta\Pi/\delta n > 0$, *if* $\gamma\, i_l\, l > (m_f/n^2)\gamma'_1\, i_l\, nl$;

v) $\delta\Pi/\delta l > 0$; $\delta\Pi/\delta m_h < 0$; $\delta\Pi/\delta i_s < 0$; $\delta\Pi/\delta O < 0$.

The effect of an increase in the interest rate on loans (i_l) on the profit will be positive if the resulting increase in income offsets the decrease in income due to lower repayment rate. The effect of an increase in the employees in the field (m_f) improves the supervision and monitoring of the use of credit and hence increases the income by raising the recovery of loans. The profit of the MFI will increase if this increase in income is greater than the wages paid to the marginal employee. Similarly, an increase in the wages paid to employees (w_f) will increase profit if the improvement in the recovery rate (due to improved supervision) exceeds the increased wages paid. An increase in the beneficiaries (n) will affect profit positively if the returns from them are greater than the decrease in recovery rate (due to increased difficulty in supervision). Finally, larger average loan size (l), fewer non-field workers (m_h), lower interest paid to savers (i_s) and lower overhead costs (O) will increase the profitability of the MFI.

5. Financing microenterprises: MFIs versus Islamic banks

In this section, we compare the relative economic performance of MFIs and Islamic banks in delivering microfinance. Note that Islamic banks will use the same format as the MFIs in microfinancing as this format suits the poor. Specifically, small amounts of credit are given to the poor with no physical collateral. In order to qualify for funds, beneficiaries have to be poor and form groups. Funds are provided under some Islamic mode of financing for three months to a year and repaid in weekly/monthly instalments. The banking activities take place at the weekly meetings at the centre. Though the bank deals primarily with women, the bank encourages the active participation of the spouse in the funded activity.

As regards the *modus operandi* of microfinance operations by an Islamic bank, the field level operations can be conducted from its branches and a small department can coordinate these operations at the head-office (national) level. At each branch, field workers will do the business under the supervision of field supervisors. An officer of the bank will oversee the microfinance operations of the branch. Microfinance operations will be focussed among the poor in the vicinity of the branch. Given the above, we can compare the relative effectiveness of providing such finance by MFIs and by Islamic banks. The results are summarised in Table 1.

Table 1. – COMPARISON BETWEEN MFIS AND ISLAMIC BANKS IN PROVIDING MICROFINANCE

MFIs	**Islamic Banks**
Operating Costs $OC^M = w^M_f m^M_f + w^M_h m^M_h + O^M$	$OC^I = w^I_f m^I_f + w^I_h m^I_h$
Borrowing Costs $BC^M = i^M_f F + i^M_s S$	$BC^I = r^I_d D + r^I_s S$
Implications of Lack of Funds (1) $m^M_f/n \downarrow \rightarrow \gamma^M \downarrow \rightarrow TR^M \downarrow$	$m^I_f/n \uparrow \rightarrow \gamma^I \uparrow \rightarrow TR^I \uparrow$
Implications of Lack of Funds (2) $w^M_f \downarrow \rightarrow \gamma^M \downarrow \rightarrow TR^M \downarrow$	$m^I_f \uparrow \rightarrow \gamma^I \uparrow \rightarrow TR^I \uparrow$
Lack of Supporting Program for poor => Fund diversion	Supporting Program for poor => No Fund diversion
Costly Training	In-house Training

a) Profitability/viability

Profitability/viability can be discussed from the revenue and cost sides. As before, the total costs of providing microfinance can be viewed as operating and borrowing costs. The operating costs of an MFI (OC^M, superscript M indicating MFI) will include costs at the head office, regional offices and branches that cover the field-level work. The costs comprise a variable component (wages to employees at the field and head-office levels= $w^M_f m^M_f + w^M_h m^M_h$) and a fixed component (rent, utilities, etc.= O^M). The total operating costs of an MFI is $OC^M = w^M_f m^M_f + w^M_h m^M_h + O^M$.

In contrast, operating costs of providing microfinance in case of an Islamic bank (OC^I, superscript I indicating Islamic bank) will be much smaller. As Islamic banks will provide microfinance from existing branches, it will not incur any extra fixed costs (rent, utilities, etc., i.e., $C^I=0$). Furthermore, it will not require a whole range of professionals/employees, particularly at the top management level at the head office and regional offices. This will reduce the cost of operations at the head-office level (i.e., $w^M_h m^M_h > w^I_h m^I_h$). Note that the wages paid to the field workers and supervisors in the case of Islamic banks is expected to be higher than their MFI counterparts (i.e., $w^M_h < w^I_h$).

As discussed above, this will have two offsetting effects. On the one hand, higher wages will attract more productive field-level workers and on the other hand it will increase the wage bill. As the field level workers are paid relatively lower salaries than professionals at the management level, the total wage bill for microfinance operations in an Islamic bank is expected to be much lower than that of an MFI. We can conclude that the total operating costs of providing a certain amount of microfinance to a given number of beneficiaries will be lower in the case of Islamic banks than in the MFIs. That is,

$$OC^M(= w^M_f m^M_f + w^M_h m^M_h + O^M) > OC^I\ (= w^I_f m^I_f + w^I_h m^I_h); \quad (8)$$
$$m^M_h > m^I_h,\ w^M_f < w^M_h\ .$$

To discuss the borrowing costs, we need to examine the sources of funds for these institutions. In the absence of deposits (other than savings of beneficiaries), the bulk of the funds of the MFIs comes from external sources. Though sometimes the external funds are provided at subsidised rates, certain conditionalities are attached to it. In contrast, Islamic banks' main sources of funds are deposits. The opportunity cost of using these funds is investment in alternative investments. Most Islamic banks, however, have excess liquidity given the lack of Islamic compatible money-market instruments to park funds for shorter periods of time. Given this excess liquidity, the opportunity cost of using these funds is zero (r^I_d=0). Assuming that the Islamic banks offer their beneficiaries the same rate of return as MFIs (i.e., $i^M_s = r^I_s$) on their savings, then we can conclude that the borrowing costs of funds will be lower in the case of Islamic banks (BC^I) than in the MFIs (BC^M), as indicated below,

$$BC^M\ (= i^M_f F + i^M_s S) > BC^I\ (= D + r^I_s S). \quad (9)$$

The above discussion shows that Islamic banks can finance microenterprises more efficiently (at a lower cost) than MFIs.

b) Quality of service

An implication of dependence on external funds is that MFIs have to abide by certain conditions. While some conditions are value neutral, others are not compatible with Islamic principles. For example, the funds from external sources are given on interest and the MFIs are required to collect a fixed return from the beneficiaries. The implication of this is that Islamic MFIs lose their independence to use certain profit-sharing modes of financing and frame procedures that may be more appropriate for financing certain activities.

In contrast, Islamic banks use their own funds and are independent to frame programs that suit the beneficiaries. For example, the revenue generated from certain activities such as agricultural production and cow-fattening have a gestation period. Thus, it becomes difficult for beneficiaries of an MFI to pay instalments, as the return from investment flows in at a later date. An Islamic bank can frame a repayment schedule where the beneficiary pays a token

(small) amount of money at the weekly meetings, and pays the bulk of the debt when the asset or produce is sold.[10]

As pointed out earlier, Islamic MFIs in Bangladesh identify lack of funds as one of the major constraints to growth and efficient operations. Other than limiting the expansion of operations of MFIs, a lack of funds also has other detrimental implications. They cannot hire sufficient workers at competitive wages. Paying lower wages implies that they employ relatively low productivity workers. Lack of funds also means employing fewer field level workers lowering the employee-beneficiary ratio, adversely affecting supervision and monitoring. Both factors increase the probability of default, γ^M, and lowering the expected income of MFIs. Islamic banks, however, can employ adequate workers at competitive wages plus other benefits. This allows them to employ productive workers and maintain an appropriate employee-beneficiary ratio. These have a positive impact on the repayment rate and income of the bank. The comparative effects of lack of funds on the revenue of MFIs and Islamic banks are shown in Table 1.

Another factor that can improve the efficiency of the operations of MFIs is periodic training and workshops to upgrade their skills of employees. Islamic MFIs contend that they cannot benefit from these costly training sessions due to a lack of funds. Islamic banks, being relatively larger institutions, can organise training courses for their employees. Larger Islamic banks have their own in-house training departments and the employees involved in microfinancing can benefit from these in-house training programs at little extra cost.

c) Complementary Poverty Reduction Program

It has been pointed out above that the poorest sections of the population are left out by conventional MFIs. One reason is that extreme poverty leads to the diversion of funds from productive activities to consumption and asset purchases. This lowers the overall return on investment and makes it difficult for the poor to repay the loans. It is also pointed out above that some charitable institutions (such as *zakat, sadaqaat*, and *waqf*) can be integrated with microfinancing to reach the core poor. The Islamic MFIs, however, have not tapped into these sources to complement financing to the poor. One reason may be the Islamic MFIs find it difficult to mobilise *zakat* proceedings from the community.

Islamic banks can devise a complementary program to finance the core poor. Most Islamic banks have a fund created from collections of penalties for late payments from overdue accounts. These funds, on principle, can only be spent on charitable activities. These funds can be integrated with microfi-

[10] This cannot be done by those MFIs in Bangladesh that take funds from government funding agency (PKSF), as a condition attached for funding is that the beneficiaries should start paying instalments of equal amounts within two weeks of the disbursement of funds.

nancing either as outright grants or interest-free loans (*qard-hasan*). This will not only prevent diversion of funds from investment to consumption by the poor, but also act as an added financial incentive to repay the funds taken for microentrepreneurs.

6. An example of microfinancing by Islamic bank: Rural Development Scheme of Islami Bank Bangladesh Limited[11]

The Rural Development Scheme (RDS) of the Islami Bank Bangladesh Limited (IBBL) was initiated in 1995 and began operations in 1996 to cater to the investment needs of poor microentrepreneurs, particularly in the rural areas. The RDS is funded from IBBL's general investment fund. As of September 1999, the RDS has provided microfinance services in 812 villages from 52 branches of the IBBL. A total of Tk.[12] 243.58 million was disbursed at a 12 per cent rate of return[13] to 23,184 clients (organised in 7,012 groups and 1,733 centres) with a recovery rate of 99 per cent. IBBL also manages the Islamic Bank Foundation (IBF), a fund created from *zakat*, charity donations and income of the bank that cannot be included in the profits of the bank.

In line with the social dimension of its operations, the objective of the RDS is to eliminate rural poverty through a community development approach. The target group of the RDS is the rural poor, defined as the landless or those households having less than 0.5 acres of arable land. Other than providing finance for microenterprises to generate income, the RDS also focuses on health, sanitation and the education of its beneficiaries. The dominant mode of financing used by RDS is *bai-muajjal* (deferred-price sale). The scheme uses the group-based format of the MFIs outlined above. Small amounts (ranging from Tk. 3,000 to Tk. 25,000) are given to individuals and repaid back in small weekly instalments. No physical collateral is required for obtaining funds. Instead, social collateral is introduced by forming groups and centres. The clients save Tk. 5 per week as personal savings and have to give Tk. 1 per week for the centre fund. Note that 2 per cent of the 12 per cent rate of return charged goes to a risk fund that is used to repay instalments of beneficiaries facing unusual problems and in case of emergencies.

As with Islamic MFIs, the RDS deals with the family via the women. The Islamic approach of targeting the family and using Islamic modes of financing eliminates, to a large extent, asymmetric information problems arising in conventional microfinancing. As mentioned earlier, this approach mitigates

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[11] The information provided in this section is based on a field survey on Rural Development Scheme and interviews with officials of Islami Bank Bangladesh Limited.

[12] Taka (abbreviated Tk.) is the currency of Bangladesh (1US$ =51Tk. in 1999).

[13] The 12 per cent rate of return is broken down as bank profit (6 per cent), supervision charge (4 per cent) and risk fund (2 per cent).

the adverse selection and moral hazard problems resulting from the fact that the intended use and user are different from the actual use and user of the funds. As Islamic modes of financing involve a real transaction, the moral hazard problem arising from the use of funds for purposes other than those intended is also eliminated. Other elements of the operations of the RDS are discussed below.

a) Profitability/viability

Figures in Table 2 below, show the cumulative accounts of the RDS up to December 31, 1998 and will form the basis for discussion on RDS profitability. Note that only variable costs, that is expenditure by the field supervisors and their expenses, (including depreciation of motor cycles, fuel costs, and other related expenditures) are incurred by the RDS. The fixed costs of rent and utilities and other fixed costs, such as furniture, do not appear as the RDS operates from the bank branch premises and does not have to pay for these services.

Table 2. – INCOME AND EXPENDITURE OF RDS UP TO DECEMBER 31, 1998

Income	**Amount (in millions)**
Income from Investment (at 6% RR)	Tk. 7.377
Income from Supervision Fund (at 4%)	Tk. 5.037
Amount of Risk Fund (at 2%)	Tk. 2.508
Expenditure	
Salary of Field Supervisors	Tk. 6.558
Other Operational Costs (Depreciation of Motor cycles, fuel costs, etc.)	Tk. 1.422
Salary of Project Officer	Tk. 3.876
(Opportunity) Cost of Funds (Tk. 64.4 million at 7.07 at per cent)	Tk. 4.553

Source: Documents provided by Rural Development Scheme, Bangladesh Islami Bank Limited.

If all the items of income and expenditure in Table 2 are used to calculate the profit of the RDS, it appears to be operating at a loss. This figure, however, may be misleading due to the following factors.

i) The rate of return charged by the RDS (i.e. 12 per cent) is lower than most MFIs operating in Bangladesh that have rates of return/interest rate in the range of 16-20 per cent. By charging a lower rate of return than the market rate, the RDS is essentially subsidising the microentrepreneurs. As a result, the income from investments is relatively lower than that of the MFIs.

ii) A major part of the expenditure goes to the salary of the project officer. The project officer, however, devotes only part of his time to the RDS activities, as he is an officer of the bank overseeing the activities of the RDS. Payment

[14] For example, Grameen Bank charges an interest rate of 20 percent. Al-Fallah, Noble, and Rescue, three Islamic MFIs operating in Bangladesh, charge a rate of return of 16 percent (Ahmed, 2002).

of full salaries to the project officer is an over-estimation of the expenditures for the RDS.

iii) The opportunity cost of funds used in microfinancing is calculated at an average of 7.07 per cent given to depositors of the IBBL. This may, however, be misleading for the following reasons. First, the IBBL, like other Islamic banks, has a large amount of liquid funds due to the lack of Islamic money market instruments. In 1998, cash held by IBBL was Tk. 8,247.8 million making the RDS disbursements only 0.47 per cent. Second, the amount needed for microfinance is miniscule compared to the total assets of the IBBL. In 1998, a disbursement of Tk. 39.1 million to the rural poor under the RDS is only 0.13 per cent of the IBBL's assets (of Tk. 30843.9 million). Given these facts, the opportunity cost of using the funds for microfinancing is close to nil.

Given the above qualifications, different scenarios regarding the profitability/viability of the RDS can be arrived at. These are summarised in Table 3.

Table 3. – PROFIT/LOSS OF RDS UNDER DIFFERENT ASSUMPTIONS (IN MILLIONS OF TAKAS)

	Income	**Expenditure**	**Profit**
Case 1: Total income – total expenditure	14.922	16.409	-1.487
Case 2: Adjusted Exp. (less opportunity costs of funds)	14.922	11.856	3.066
Case 3: Adjusted Exp. (less Project officers salary)	14.922	12.533	2.389
Case 4: Adjusted income (16 per cent rate of return)	19.896	16.409	3.487
Case 5: Adjusted income & expenditure (Cases 2 & 4)	19.896	11.856	8.04
Case 6: Adjusted income & expenditure (Cases 3 & 4)	19.896	12.533	7.363
Case 7: Adjusted income & expenditure (Cases 2, 3, & 4)	19.896	7.98	11.916

When expenditures on all heads are included (salaries of the project officer and opportunity cost of funds) then the RDS incurs a loss of Tk. 1.487 million. As mentioned above, however, the funds are provided to beneficiaries at below the market rates and a couple of expenditure heads cannot be directly charged to the RDS. When these adjustments are made, the RDS operates at positive levels of profit. Different cases involving these adjustments are possible. If the cost of the fund is excluded (as the opportunity cost of these funds is close to zero), then the RDS operates at a profit of Tk. 3.066 million (Case 2 in Table 3). Similarly, when salaries of project officers are excluded (as they work only part-time for RDS) the scheme earns a profit of Tk. 2.389 million (Case 3).

On the income side, note that the income figure is based on a rate of return of 12 per cent. To cover all expenditures during the period (including the cost of

capital and project officers' salaries), the breakeven rate of return is estimated at 13.2 per cent. The rate of return charged by the RDS is much lower than that charged by other MFIs. If the income of the RDS is calculated at the lowest rate of return of 16 per cent charged by other Islamic MFIs, then the profit with this rate of return under different assumptions of expenditures are shown in Cases 4-7. Note that the RDS would operate on profit at a 16 per cent rate of return, even when the cost of funds and salaries of project officers are included (case 4). The largest profit is derived when all the adjustments in costs and income heads are made (Case 7).

b) *Quality of Service*

The quality of service provided by the RDS will be much better than Islamic MFIs for several reasons. First, the IBBL can attract better employees as they offer a better benefit package. Not only do field supervisors received better pay, but they also receive other benefits associated with working in an established financial institution. Second, all employees in the RDS are trained at the Islami Bank Training Academy at no extra cost to them. The high quality in-house training provided by professionals in the training Academy improves the skills of the workers increasing their productivity. Third, the field level workers can perform their banking services more efficiently due to better logistics support. For example, whereas field workers of most Islamic MFIs use bicycles to go to the weekly meetings and visit beneficiaries, those of the RDS use motorcycles. Fourth, RDS employs sufficient workers to keep an ideal employee/beneficiary ratio. This helps them to monitor clients and supervise the funds more efficiently. Fifth, as the RDS is not dependent on external sources for funds, it can frame its program in a manner that is suitable to the beneficiaries. For certain activities, an instalment repayment scheme that corresponds to the income stream of the funded activity can be arranged. This practice does not burden the beneficiaries when there is no income generated from the investment.

c) *Complementary Poverty Reduction Program*

The RDS has been successful in integrating other support programs together with the microfinance scheme. As mentioned earlier, poverty induces people to divert funds to consumption and purchase of other assets. The RDS uses funds from the Islami Bank Foundation for a complementary program for asset building. The clients can obtain interest-free loans (*qard-hasan*) from this fund to buy assets (like tube wells) and housing. This not only builds the asset base of the beneficiaries, but also affects the repayment rate positively as funds are not diverted for non-productive purposes. Furthermore, as default and arrears disqualify beneficiaries to obtain interest-free loans, this facility acts as an incentive for them to repay the instalments on time.

7. Conclusion

A distinguishing feature of the Islamic banks is the social role in their operations. As microfinancing enables the increase in income and wealth of the poor, it is considered a new paradigm to poverty alleviation and brings about development. The paper argues that the social aspect of Islamic banks can be best realised by financing the poor mircoentrepreneur. The paper discusses the operations of conventional MFIs and examines their strengths and weaknesses. While conventional MFIs have successfully resolved the credit risk problem by instituting group-based lending and collecting weekly instalments, the problem of economic viability still pose difficulties to them. As group-lending and weekly repayments effectively resolve the credit risk problem in financing the poor, these aspects can be adopted by Islamic banks providing microfinance.

The paper contends that Islamic banks can provide microfinancing by avoiding certain problems faced by conventional and Islamic MFIs. Theoretical arguments are given to show that microfinance can be provided to the poor more efficiently and effectively by Islamic banks than by MFIs. Well-established Islamic banks can benefit from their scale of operations. As Islamic banks do not depend on external sources, their microfinance scheme can adapt to cater to the special needs of the beneficiaries. Islamic banks can also operate a complementary support program together with microfinancing to target the core poor.

The paper presents a strong case for Islamic banks to facilitate wealth creation of the poor through involvement in microfinancing. As more and more conventional banks begin to provide Islamic financial services, the 'spirit' of Islamic banks reflected by their social role will distinguish Islamic institutions from non-Islamic. Contrary to what one might believe, the paper shows that implementing the social function by financing the poor will not be a financial burden to Islamic banks. Instead, Islamic banks are predisposed to provide microfinance in a *win-win* situation. That is, Islamic banks can operate microfinance programs at no extra cost and improve the economic conditions of the poor. Experience from the RDS of the Islamic Bank Bangladesh Limited and Islamic Development Bank supports this fact.

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